NOMINATION OF MARTIN S. FELDSTEIN

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

THE NOMINATION OF

MARTIN S. FELDSTEIN TO BE CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS

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NOMINATION OF MARTIN S. FELDSTEIN

WEDNESDAY, SEPTEMBER 22, 1982

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met, at 10 a.m., in room 5302 of the Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Brady, Riegle, Proxmire, and Dodd.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

The purpose of this morning's hearing is to hear testimony on the President's nomination of Mr. Martin S. Feldstein to be Chairman of the Council of Economic Advisers. I've had the opportunity to meet with Mr. Feldstein prior to the hearing and I would say that I think the President has made an excellent choice for this position. I have no doubt in my mind that he will be an excellent adviser to the President, and also as Chairman of the Council of Economic Advisers.

So we welcome you here this morning. Before we start, if I could ask you to stand and be sworn.

Do you swear the testimony you're about to give is the truth, the whole truth, and nothing but the truth, so help you God?

Mr. FELDSTEIN. I do.

The CHAIRMAN. Mr. Feldstein, do you have an opening statement that you wish to make?

STATEMENT OF MARTIN S. FELDSTEIN

Mr. FELDSTEIN. Yes, I do, and I'll read that now.

I am very honored to appear before this distinguished committee as President Reagan's nominee to be Chairman of the Council of Economic Advisers. This is a critical time for our economy and for our Nation. It is a formidable challenge and an awesome responsibility to provide economic advice to the President at this juncture. I nevertheless welcome the opportunity to provide this professional service to my country.

Our Nation now faces several very serious economic problems. None is more obvious than that over 10 million Americans are now unemployed. In many families, this unemployment means severe financial hardship and personal suffering. Nearly 2 million people have been unemployed for longer than 6 months. Moreover, high unemployment in our country is not just associated with reces-

sions. Even when economic activity is at its peak, unemployment remains unsatisfactorily high. At the past two business cycle peaks, over 6 million persons were unemployed.

The extremely high current level of unemployment is the result of the increasingly rapid inflation that afflicted our economy during the past 15 years. The overall rate of inflation rose from an average of only 2½ percent in the sixties to more than 6 percent in the first half of the seventies and more than 8 percent in the second half of the seventies. The Consumer Price Index finished the decade with a jump of more than 13 percent in 1979 and started the current decade by rising more than 12 percent in 1980. There was a widespread and justifiable fear that the inflation rate might continue to increase until it spiraled out of control.

The substantial decline in the growth of the money stock that occurred in 1981 stopped the rising rate of inflation. More precisely, the slowdown in the expansion of the money stock decreased the growth of nominal GNP; that is, of GNP measured at current prices. Part of this slowdown in nominal GNP took the form of lower inflation and part of it took the form of a decline in real economic activity. If the rate of inflation had declined faster, the recession would have been milder or might even have been completely avoided. But sticky wages and prices are an unfortunate feature of our economy and imply that inflation can only be reduced at the cost of a temporary reduction in output and employment. The extremists among both the supply siders and the rational expectations monetarists who predicted that inflation would be reduced without raising unemployment have been decisively proven wrong.

The progress against inflation has, nevertheless, been very substantial and much more rapid than many economists, especially those with a Keynesian perspective, expected as recently as last year. The consumer price index in 1982 has been increasing at about half the rate of increase in 1979 and 1980. Producer price increases have also dropped sharply and wage inflation is beginning to decelerate. Although monthly inflation rates will remain volatile in the year ahead, the underlying inflation trend is now definitely pointing down.

Economic recovery need not be accompanied by a new round of rising inflation. There is now substantial slack in the economy and many firms are in a good position to increase output without raising prices. It is extremely important, however, to avoid overstimulating the economy as it enters the recovery. Experience has shown that attempts to fine tune a recovery are frequently self-defeating. The use of expansionary monetary and fiscal policies to accelerate a recovery has requently caused an increased rate of inflation or a short-lived recovery. I sincerely hope that the very high price in unemployment and lost output that we are now paying to reduce inflation will deter future governments and monetary authorities from pursuing policies that might rekindle the inflationary spiral.

The economic recovery will reduce the unemplolyment rate but will not eliminate the problem of unemployment. Even when capacity utilization is high and further increases in demand would only increase inflation, the unemployment rate will remain uncomfortably high, probably between 6 and 7 percent, if nothing is done to correct the fundamental causes of high unemployment. There

are important structural problems in the labor market that must be tackled successfully if the permanent rate of unemployment is to be lowered. Nearly half of the unemployed are less than 25 years old. Their unemployment reflects the inefficiency of our labor market in matching people and jobs rather than any overall lack of demand. New ways must be found to strengthen the skills and incentives of prospective workers of all ages and to deal with the special problems of unemployment in those industries that have lost competitiveness in the world economy. These are long-run problems, but we should start tackling them as soon as possible.

The other basic long-run goal is to increase the productivity of the work force and thereby to raise their real earnings and their standard of living. Although many things contribute to labor productivity, capital accumulation in the form of business plant and equipment is the channel that is most influenced by government policy. Countries that devote a larger share of their national income to investment enjoy a faster increase in real incomes.

U.S. investment in plant and equipment has been pathetically low. For the past two decades, the United States has saved and invested some 15 percent of GNP. Since three-fifths of that investment has been needed just to replace the capital stock that is wearing out, only 6 percent of GNP has actually been devoted to net investment that increases the net capital stock. This 6 percent net investment rate is less than half of the average among the other industrial countries of the OECD. Moreover, since half of this 6 percent net investment has gone into housing and inventories, only 3 percent of GNP has been used to increase the real net stock of plant and equipment used by our Nation's business, very much less than half of the rate in other industrialized countries.

Our ability to invest as a nation is ultimately limited by the supply of savings provided by households, businesses, and governments. Our low national rate of saving reflects primarily a wide range of Government policies, from tax rules that penalize saving and discourage business investment to credit market rules that limit the rate of return available to the small saver. These antisaving Government policies can be traced ultimately to the Keynesian fear of saving that has permeated economic thinking and economic policy for the past 40 years.

As you may recall, Keynes argued that the British depression of the 1930's was due to inadequate spending or, equivalently, to excessive saving. The implication of his theory was therefore clear: develop explicit policies to discourage saving and encourage consumer spending. This theory, designed for the British depression of the 1930's, came to have a powerful and inappropriate effect on the economic policy of the United States and Britain in the 1950's and 1960's, and 1970's. While the continental European and Japanese governments have been telling their citizens with both words and incentives that saving would create the capital for better jobs and a high standard of living, our Government was induced by the Keynesian fear of saving to tell the American public that saving less and spending more on American made consumer goods was the key to jobs and prosperity. Unfortunately, this combination of adverse incentives and misguided cajoling was so potent that the

United States and Britain have experienced the lowest saving rates in the industrial world during the past two decades.

Fortunately, all that is now beginning to change. Within the economics profession, there is a widespread retreat from the Keynesian notion that the way to raise income is to expand demand. Instead of Keynesian demand management, the new view focuses on capacity creation through capital formation, research, and innovation. I believe that this is the essence of supply side economics. I think it is most unfortunate, therefore, that this idea of stimulating supply rather than demand got a bad name when the label "supply-side economics" was attached to some extreme rhetoric about self-financing tax cuts and to euphoric forecasts of a painless transition to rapid but inflation-free growth. Although I reject such extremes, I do believe that it is very important to revise Government policies to stimulate supply by creating capacity and by reducing disincentives and barriers to individual effort.

The importance of increasing capital formation was clearly recognized in the 1981 tax legislation. There was strong bipartisan support for several substantial changes aimed at encouraging individuals to save more. I believe that the tax changes that were made last year will gradually increase the rate of saving in the economy. I am also convinced that more needs to be done to remove the savings disincentives created by Government policy, in order to encourage individuals to save more.

The sections of the 1981 tax bill relating to business concentrated on lowering the effective tax rate on corporate source income and thereby stimulating business investment. Although the 1982 legislation undid some of the provisions enacted in 1981, the combination of the 1981 and 1982 legislative changes and the lower rate of inflation does mean that the effect of taxes on the incentive to invest in plant and equipment is generally greater today than it was only a few years ago. But that is not enough. The effective tax rate on nonfinancial corporations, their shareholders and their creditors has increased sharply since the mid-1960's and this tax rate continues to discourage investment. By the late 1970's, taxes took more than two-thirds of the return to the capital invested in these businesses. The low rate of investment is reinforced by the high real interest rates that are caused by Government deficits and the fear of future Government deficits. I think that Congress and the administration should reexamine the problem of capital formation and try to devise additional ways to stimulate a high permanent level of business investment.

Our Nation's rate of saving reflects not only the decisions of households and businesses but also the amount of saving or borrowing done by the Federal Government. Federal deficits compete directly with private investment for the resources made available by private saving. The projected deficits of 4 percent or more of GNP represent a drastic reduction of our potential rate of net investment. One of the most difficult but most important challenges now facing the Congress and the administration is to find ways to reduce the projected deficits without distorting economic incentives by inappropriate tax increases, without hurting the poor by badly designed spending cuts, and without weakening our potential capability for national defense by unwarranted reductions in military

outlays. Shrinking the projected deficits will require a creative reexamination of our tax and spending programs with careful attention to the economic and military consequences as well as to the budgetary effects. But I firmly believe that the deficit can be gradually eliminated and that this can be done without violating our goals of protecting the poor, strengthening military security and reducing the burden of distortionary taxation.

I have focused my remarks on the structural problems that face our economy rather than on the current condition of the business cycle. I think that emphasis is correct. As I noted earlier, excessive fine tuning during the past 15 years has been contributing to our economic problems rather than curing them.

The economy now seems about ready to recover. Real GNP should be higher in 1983 than in 1982. In a recent national survey of 43 leading private economic forecasters, the expected growth of real GNP between 1982 and 1983 averaged 3.5 percent with half of the forecasts between 2.9 and 3.9 percent. If the current mix of macroeconomic policies is not altered, it does not seem unreasonable to believe that the actual GNP growth will be in that range. It is difficult, however, to predict the near-term outlook with both precision and confidence, especially when the economy is near a turning point.

The recent decline in interest rates provides a welcome relief to financial markets and should provide a stimulus to spending by business and households. It is important to recognize, however, that interest rates may continue to rise and fall. We should not be disturbed by these oscillations and should not try to eliminate them by a fine tuning of monetary policy or by redirecting monetary policy to focus on interest rates as such. I believe that as inflation continues to decline the basic trend in market interest rates will also be in a downward direction. Even if the economic recovery causes a temporary rise in real estate rates, the effect of the high rates will be to dampen the recovery and not to end it. It is far better to have a sound and gradual recovery than one that rapidly overheats and fails to persist.

The Council of Economic Advisers will, of course, keep a careful watch on all of the economic indicators to make certain that the recovery is moving forward. In addition to the work done by the Council's own staff, the Council will coordinate the forecasting activities of the Treasury and the Office of Management and Budget. The private sector is now devoting very substantial resources to the process of economic forecasting. The Council will closely monitor the private forecasts prepared by the industrial and financial corporations as well as by economic forecasting organizations.

The 1980's can be a major turning point for the American economy. After more than a decade of rising inflation, declining productivity, and an increasing share of taxes and government spending in the national economy, we are ready for a change. Among professional economists, there is a retreat from a Keynesian economics characterized by a misdiagnosis of unemployment, an unjustified fear of saving, and an unwarranted optimism about the positive effects of government spending and activist demand management. In its place, there is a return to the basic economic truth that a nation's wealth and prosperity depend ultimately on its capacity to

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produce and therefore on its stock of physical capital and the skills and efforts of its labor force, its entrepreneurs, and its investors. I hope that I can work with the President and with the Congress to help build sound economic policies on the basis of that truth.

The CHAIRMAN. Thanks very much. I understand that you and your wife will place your marketable securities and your shares in Economic Studies, Inc. in a qualified blind trust; is that correct?

Mr. FELDSTEIN. That is correct.

The CHAIRMAN. So what you are saying, then, is that you will avoid even the appearance of conflict of interest in your service as Chairman of the Council of Economic Advisers.

Mr. FELDSTEIN. That is correct. We've discussed that with the Office of Government Ethics.

The CHAIRMAN. Will you be willing to appear before this committee and other commitees of the Congress when requested?

Mr. FELDSTEIN. I will, happily.

The CHAIRMAN. In a prepared statement that will be delivered later this morning, the National Association of Home Builders urges this committee to reject your nomination. With regard to your support for "more productive capital investment," the NAHB statement says that:

> Young people are not concerned about which brand and model of personal home computer to purchase. The dream of home ownership for rich and poor has not died; hopefully it is only temporarily deferred for the 41 million Americans who reach the age of 30 during this decade.

Do you believe the policies you expound would provide adequate housing for those 41 million Americans?

Mr. FELDSTEIN. I have no disagreement with what you read from the Home Builders Association. As I said in my statement, I'm very much in favor of increased savings. If we have more saving, we'll have more capital formation of all kinds, including housing, as well as business plant and equipment.

But I think the young people care not just about housing, but also about their real incomes and about the productivity of the jobs in which they work. That's directly related to the amount of capital that goes into those jobs.

The CHAIRMAN. The charge has been made that you are antihousing because you have supported policies designed to channel more of the economy's available savings into investments in new factories and machinery rather than into housing.

How do you respond to the charge made by some that you are antihousing?

Mr. FELDSTEIN. I don't see myself as antihousing; I see myself as very much procapital formation of all kinds. I would like to see a larger share of the larger capital stock devoted to plant and equipment. That doesn't mean that we have to have less housing if we're prepared to go forward and have more capital.

The CHAIRMAN. You have argued that our present mix of fiscal and monetary policies will keep real interest rates above their levels in the 1960's and 1970's. What would you say to homebuilders who are afraid to start new houses because they fear, in light of your statements on real interest rates, that affordable, permanent financing will not be available when the houses are completed?

Mr. FELDSTEIN. Well, I think we are beginning at last to see the cost of funds for homebuilding coming down. Interest rates in the secondary mortgage markets are dropping. The actual rates being charged for new mortgages are beginning to come down. I discussed just yesterday with the Undersecretary of Housing a new mortgage instrument, a 15-year mortgage instrument that they have been working on with the private sector, that will provide an 11-percent interest rate. He tells me that it's being very well received by those who are lending money on those terms.

So I think that we're moving toward a more affordable housing in the near term.

The CHAIRMAN. So your statements in the past have not been that you want to rob Peter to pay Paul and take money from housing, but you believe that by increasing the entire availability of savings and capital formation, that it will provide more capital for all segments.

Mr. FELDSTEIN. That is exactly my preferred route. I would like to see more capital formation, rather than having to take it out of one thing to put it into another. The figures that I read in my statement, about 6 percent of GNP being devoted to all net investment, includes housing, includes inventories, and includes all business plant and equipment. I think we should have a much higher number than that 6 percent. Then there will be enough to go around for all kinds of uses.

The CHAIRMAN. The allegation has been made by some that the prospective deficits that we have heard so much about lately are the result of cutting taxes too much in 1981. Do you believe that we actually cut taxes in 1981, or did we just slow the growth in increase in taxation, which results, as we all know, from bracket creep?

Mr. FELDSTEIN. Well, bracket creep has been a major problem. It has pushed taxpayers to higher and higher brackets and led to more and more taxes being taken from them as a share of their income.

The 1981 tax cut, or series of tax cuts, stretching out through 1983, do amount to a net tax reduction, both for individuals and for businesses. Part of it, the largest part of that 5–10–10 personal rate cut, is just an offset to bracket creep. But over the period from 1981 to 1984, before indexing begins in 1985, there will be a noticeable, a significant tax reduction, bringing us back in the direction of the kind of tax burdens we had earlier.

The CHAIRMAN. You are known for your advocacy of increased capital investment in new factories and machinery. How do you respond to those analysts who argue that future competitive advantage of our economy will lie in the services industries? This is where we should focus our investments rather than in traditional manufacturing.

Mr. FELDSTEIN. Well, I have never favored one industry rather than another for capital formation. I think we should leave that to the capital markets. I think we should have more capital out there to be invested. Some of that will go into the service industries. When offices develop and use higher technology, that is part of the service industry investment and it leads to productivity increases every bit as much as when factories order new machinery and in-

creased the productivity of that part of the work force. I don't have any preference between them.

I do think, though, that the growth of the service sector relative to the industrial sector in our economy has, in part, occurred because of our low rate of capital formation. Because we have less capital available, more of our industry has to develop in the less capital-intensive sector, the service sector.

I don't think that we should prejudge where that growth will be in the future or cut it off from the industrial sector by not having the capital available.

The CHAIRMAN. The allegation is made constantly that today's monetary policy and fiscal policy are in conflict. The monetary policy is too tight, while fiscal policy is too stimulative.

Do you agree with that statement?

Mr. FELDSTEIN. No, I don't agree with that. I think that the two policies are moving in a coordinated way. I think that monetary policy is correctly focusing on the inflation rate. I think the previous failure of monetary policy to focus on holding down the growth of nominal GNP is the source, one of the key sources, of our increasing inflation in the past and that the monetary policy is appropriately aimed.

I think, at the same, fiscal policy, particularly the targeted, prosaving, proinvestment tax changes that were enacted in 1981 will support a long-run shift toward a greater rate of capital formation.

I think between the two of them, we're moving toward lower inflation and higher productivity.

The CHAIRMAN. The Congress has before it a proposal to require the Federal Reserve to return to their pre-1979 policy of controlling real interest rates. What's your opinion of that proposal?

Mr. Feldstein. I think it would be a serious mistake. I think it would be a mistake for several reasons, but two in particular. I think there would be a temptation, as there was in the past, to expand the money supply excessively. That would lead to ever-increasing inflation. You would be back in just that problem. The only way we would correct the situation again in the future would be to go through another round of very painful unemployment.

There's another reason that that worries me. Quite apart from the temptation to use it inappropriately is just the technical difficulty of using an interest rate target. The real interest rate is not the right rate, even if one could do that exercise correctly. The real interest rate is not the rate that governs savings decisions and it's not the rate that governs investment decisions. The rate that governs those decisions is the real after-tax interest rate.

The real interest rate can remain constant through time as the inflation rate rises and falls and the real after-tax rate will swing very substantially.

If you think back to the 1960s, when inflation rates were 2 percent and mortgage rates were 6 percent, you had a real interest rate of about 4 percent. Look what happens to somebody who was in a 40 percent tax bracket at that time. That 6 percent would cost him, after tax, 3.6 percent and after tax and inflation, would cost him a plus 1.6 percent. So his real after-tax rate was 1.6.

Now ask what happens if the economy moves to 10 percent inflation and keeps the same real interest rate; 10 plus 4 is 14. So the

interest rate that individuals would have to pay would be 14 percent.

If I can continue this bit of arithmetic, that same taxpayer, homeowner, would get to deduct for tax purposes 14 percent. His after-tax cost of funds would be 60 percent of 14 percent, or 8.4 percent. His after-tax real cost of funds would be minus 1.6 percent.

So although the real interest rate had remained constant between those two episodes, the real after-tax rate went from a plus number to a minus number. Now that's clearly not what's wanted.

What's intended, I think, by those who are urging us to think about interest rates is that the same degree of monetary stimulus or tightness be present. But you can't do that by controlling real interest rates. It's much more complicated in an economy with a complex tax structure in which different borrowers and lenders face very different tax rates, depreciation rules, and other things.

I think it's an impossible technical task to use an interest rate guideline instead of focusing on the long-term growth of the aggregate.

The CHAIRMAN. Senator Riegle?

Senator RIEGLE. Thank you, Mr. Chairman, and I want to get right into it because there's a lot to cover and we have a lot of members here. I must also go across to the House side and testify on a domestic content bill.

But first let me say I appreciate your willingness to come into public service and I appreciate your background, so that when I ask you some blunt, tough questions here, I don't want them taken in a personal way. I'm interested in your attitudes, the kind of job you can do, and I'm very concerned about where this country is going economically.

I think the administration thus far has done a terrible job of responding to our problems. We're sitting here 2 years after the Reagan administration took office with over 11 million people out of work. The unemployment rate in my State of Michigan is 15.2 percent. Even that doesn't count over 100,000 workers that are no longer included in the statistics because they've exhausted their unemployment benefits. And we have virtual depression conditions in a number of major industries in this country, including the housing industry, representatives from which will testify here later.

I'm also disturbed that there is not only a lack of realization in the administration of how desperately serious these economic problems are and the level of hardship imposed on people, but I think that there is a very large degree of insensitivity to what these problems mean. I've thought about it and I've watched it over a long period of time and I have not seen these issues faced squarely.

Your predecessor, Murray Weidenbaum, was very uncomfortable when he was pressed hard in his last appearance in this committee on what were clearly false and phony midyear economic forecasts by the administration. And Secretary Regan was obviously also embarrassed by them. I trust, as a professional economist, you're embarrassed by them, too, whether you're prepared to say so here today or not.

No one in the country believes them. You can't find a person on Wall Street, among the President's strongest supporters, who be-

lieves those midyear economic forecasts. And if you go back to last year, in the Atlantic magazine article where David Stockman confessed as the way the initial forecasts were put together on the economic program, it was obvious that we were not going to get the results that were advertised. And so the computer program was changed to give what appeared to be better results and so forth.

You have very obliquely in your statement, sort of touched on that—the suggestion that maybe the mix wasn't quite right.

But what I am concerned about here is whether we're going to get honest numbers, honest projections, and whether we're going to straighten this situation out. It was not until he resigned as chairman that Murray Weidenbaum spoke out publicly about the outrageous increase in the defense budget, which we cannot afford and which goes way beyond both our defense needs, our economic capacity, and our financial capacity.

I don't know if you'll be as honest or if you share that view. I wish he had been as honest when he was in the job as he has been since leaving the job.

I'm also concerned about your views on housing. I just asked a question of the staff concerning what your net worth is. I'll tell you why in a minute. They said your net worth was in excess, apparently, of $1 million.

Is that accurate?

Mr. FELDSTEIN. I don't think that's accurate.

Senator RIEGLE. What would you put it at?

Mr. FELDSTEIN. I would put it somewhat less than that. Not a lot less than that. Less than a million.

Senator RIEGLE. But in the range of a million?

Mr. FELDSTEIN. Somewhat under a million, but in the range.

Senator RIEGLE. Is it above $900,000?

Mr. FELDSTEIN. I don't know. It really is a complicated thing to calculate because you think about things like pension benefits, valuing a house, and all that. But say somewhere over three-quarters, over $750,000.

Senator RIEGLE. Well, that's a very substantial net worth. That would certainly put you, I would think, in the top 1 percent or maybe the top 2 percent of individuals in the United States, and I think that's a very fine accomplishment.

But this administration, in my view, is top-heavy with millionaires, multimillionaires, or near-millionaires, which by itself, wouldn't mean anything if there was a discernible sensitivity about what's happening to people who are not millionaires in this country, which means most people.

And when I see the views on housing that you have expressed—you have two children; I have three children. If your children at a later point in time are not in a position to get a home mortgage because they can't come up with the down payment or they can't afford sky high interest rates, if you wish to, you can help them. And that's true of most other people in the President's Cabinet, they're in a position to help their children purchase a home if the outside market conditions will not allow them to get mortgages.

That's not true for most people in this country. And it bothers me because I think that there's a growing lack of awareness and

understanding and sensitivity to what these economic policies are doing to rank and file people.

I was just at a steelworkers' picnic in Midland, Mich. and I was talking with steelworkers who are right on the verge of retirement, who are in their early 60's and they were trying to decide their retirement plans and so forth. This is what they were saying to me—that over their own lifetimes of hard work, about the only equity that they have accumulated has been the equity in their homes. They have some modest amount of net worth in some cases, but essentially, their home is their principal asset. And they are coming now into a retirement period, hopefully counting on social security, which, by the way, is under attack by this administration and which you, yourself, have attacked in terms of statements that you have made, which I also want to question you about. Right now they're seeing a situation where their sons and daughters can't find work. Those that might be fortunate enough to have a job cannot come up with the capital to buy a house.

So these mothers and fathers who are approaching retirement age are having to fundamentally change their retirement plans and take second mortgages on their house in order to get enough capital out to perhaps be able to make a loan to their sons and daughters so that they can get started with home ownership.

Now I happen to think that home ownership is important. I think it is a driving, central requirement and a very high national goal in this country. I can't find you saying that in your writings. I find you in the theoretical positions you put forward, the notion that we're spending too much on housing. And the suggestion is that maybe housing ought to be harder to purchase and it ought to be more scarce and resources ought to be diverted some other way.

Well, how do we accommodate, then, the legitimate housing needs of people? You have a house. Presumably, your children are going to have a house. But what about everybody else? What's the prospect for them?

Mr. FELDSTEIN. Can we start with that question?

Senator RIEGLE. Yes.

Mr. FELDSTEIN. I would mention what I said earlier to Senator Garn. I am not antihousing. I believe in more saving and more capital formation. I think if we have more saving and more capital, we will have more housing, as well as other kinds of capital.

One of the first popular pieces that I wrote dealt with the problem of the kinds of mortgages that currently prevent people, especially young people, from buying a house. This was a newspaper column that my wife and I wrote a few years ago, in which we commented on what had happened to the monthly cost of buying a house. We pointed out that with the conventional, fixed payment mortgage, many people were squeezed out of that market and that that was one of the adverse consequences of inflation—people could just not handle the monthly cash flow. There are two ways to deal with that. One is to bring down the rate of inflation so that interest rates can come down. And fortunately, that is happening. And the other is to change our mortgage instruments. I think that the conventional, fixed monthly mortgage is a barrier, especially to a young person who looks forward to rising income and a rising ability to pay in the future.

And I hope we will see, as we've begun to see since I wrote that column with my wife about 2 years ago, we've begun to see more creativity on the part of the financial institutions generating options that make it easier for people, especially young people at a time in their lives when their incomes are rising, to acquire and finance their own homes.

Senator RIEGLE. Well, let me just quote you a statement that you made, which I'm sure you'll recall. And you say here: "I think that the normal level"—you're referring to housing here in the 1960's and early 1970's—"may not return. I think that as a nation we're overhoused because we have created a series of incentives and financial institutions designed to create that and that was explicit policy in the immediate postwar period."

My question is this—are we overhoused or not? You apparently think we are. I don't think we are. I think we're underhoused. Now are we over or underhoused? I mean, regardless of incentives, are we, in fact, overhoused, in your opinion?

Mr. FELDSTEIN. If we had more capital, then we could afford to have the amount of housing we have now. If we remain with this extremely low, the lowest of all the industrial countries, net rate of capital accumulation, then I would say that we're devoting too large a share of it to housing relative to the kinds of capital that increase productivity and improve jobs.

Senator RIEGLE. Well, I think that is a fundamental question. I think it's an important question for the country. I believe that many people would disagree with you, because you're not just juxtaposing those trade-offs. We're talking about the defense budget. We're talking about the neutron bomb, the MX missile. We're talking about any number of other capital requirements.

Mr. FELDSTEIN. No, they're not part of the investment that I'm describing.

Senator RIEGLE. Well, but they ought to be. You just can't close the frame down here to fit some narrow, ideological supposition that you may have. We're talking about all the net flows of capital in this country.

Mr. FELDSTEIN. It's not an ideological supposition; it's a national income accounting definition. The investment that I'm describing includes private investment of all kinds.

Senator RIEGLE. Is it possible that if we spend less money on defense, that we'll have more money for things like housing? Is that not true?

Mr. FELDSTEIN. If we spend less money on all parts of the Government and have smaller Government deficits——

Senator RIEGLE. That's not my question.

Mr. FELDSTEIN [continuing]. We'll have more—but I just want to clarify that is true of all kinds of Government spending, defense spending, all other kinds of spending.

Senator RIEGLE. Is it not true that if we don't increase the defense budget at a 12 percent real rate of growth or 9 percent real rate of growth, but something less than that and we made the decision to divert those assets in a different direction, be it housing, be it job creation, in fact, we could do more in those areas, could we not?

Mr. FELDSTEIN. We could certainly divert those resources to something else if that was the national decision.

Senator RIEGLE. Now let me cover one other thing here because I have in front of me your own net worth statement. It's confidential and I'm not going to reveal the numbers here to this committee. I assume you prepared this.

Mr. FELDSTEIN. I did with counsel.

Senator RIEGLE. I assume the numbers are accurate.

Mr. FELDSTEIN. I believe they are.

Senator RIEGLE. The numbers show a net worth well in excess of a million dollars. Now is that something that you're not aware of, or is this document wrong or is your earlier answer just not correct?

Mr. FELDSTEIN. I believe the document you have there is right. But what I said before about the conceptual problem of how you handle pensions, how you handle shares in corporations that are not publicly traded is a difficult thing to value.

Senator RIEGLE. But Dr. Feldstein——

Mr. FELDSTEIN. I'm happy to live with that number.

Senator RIEGLE. But let's be very direct and honest with one another. You put this statement together and that's the purpose of the statement, to take things that are difficult to quantify and to quantify them. And you've quantified them. I would assume that this represents your best professional judgment.

Mr. FELDSTEIN. It is what my lawyer told me was the best way to answer those questions. They are, really, accounting questions rather than economic questions as to how you define——

Senator RIEGLE. Well, is this an accurate statement?

Mr. FELDSTEIN. It is. It is. I have no problem with the statement.

Senator RIEGLE. Well, but you do have a problem.

Mr. FELDSTEIN. I'm sorry that I didn't remember the amount before because it's not a number that I had ever calculated in that way before. I never had occasion before to do that kind——

Senator RIEGLE. But you've seen this document.

Mr. FELDSTEIN. I have, indeed. I've signed it.

Senator RIEGLE. And you're familiar with it.

Mr. FELDSTEIN. Yes.

Senator RIEGLE. And you signed it, I assume, when you submitted it.

Mr. FELDSTEIN. Right.

Senator RIEGLE. And it does, in fact, show a net worth well in excess of $1 million, does it not?

Mr. FELDSTEIN. If you say so. You have it there. I believe it.

Senator RIEGLE. Let's get off on an honest footing with one another here because if we can't agree on something as simple as this——

Mr. FELDSTEIN. I believe it, sir. I believe it.

Senator RIEGLE. I want you to see it, because there shouldn't be any ambiguity about it.

[Pause.]

Senator RIEGLE. So the number is clear, I take it, as you take a look at that document.

Mr. FELDSTEIN. It's clear.

Senator RIEGLE. Thank you, Mr. Chairman.

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The CHAIRMAN. Senator Brady?

Senator BRADY. I'd like to reserve my time, Mr. Chairman.

The CHAIRMAN. Senator Proxmire?

Senator PROXMIRE. Mr. Feldstein, you have an eminent academic background and you're obviously a very bright man. You graduated Phi Beta Kappa from Harvard. That's about as good as you can get. So I have great admiration for your capability and I have a policy of always supporting people who are well qualified, even though I disagree with them vigorously in their policies.

On the other hand, in your case, I must say that I do have some hesitation. And let me indicate why, and I hope that you can disabuse me.

You said in response to Senator Garn just a few minutes ago, you said, fiscal and monetary policy are moving in the same direction. Between the two they're moving in the direction—this is what I heard you say. Maybe I misunderstood it—toward lower interest rates and lower inflation.

How can fiscal policy be moving toward lower interest rates and lower inflation when we're told that we face $155 billion deficit next year and a deficit probably as big in the following years, even including the tax increase that the Congress passed?

Mr. FELDSTEIN. What I thought I said before was that the two policies were moving toward lower inflation and interest rates and also higher capital formation. But to answer the specific question that you asked, the main thing that makes interest rates as high as they are today is the inflation expectation. The real rates are much lower than the market rates that we perceive. The market rates are just a shade under 12 percent for long-term bonds now. That's not the real rate. It reflects an expectation of inflation of 6, 7 percent over the long term.

As that inflation expectation comes down, we're seeing those interest rates come down.

As you know, over the last year or so, interest rates have come down at the same time that the budget deficit and the projected budget deficit has increased. The reason that the rates have come down is that people are having more confidence that the Fed is doing its job right——

Senator PROXMIRE. Let me just interrupt you at that point to say that the real interest rates haven't come down because of the recession. They have come down because the housing industry is flat on its back. People aren't borrowing money in order to buy homes. The auto industry has been driven to its knees because, as you know, people have financed their purchase of cars and the monthly payments on cars they can't afford. Farmers can't afford to buy farm implements.

We have a situation where recession has driven interest rates low and the anticipation on the part of many people. That's why long-term interest rates, I understand it, are high, is that once we begin a recovery, the Federal Government is going to be borrowing money and crowding the private sector out.

Isn't it true that in 1970–71, the Federal Government took $1 out of $6 of new credit? Last year it took $2 out of $6. Next year it's going to take $3 out of $6 of new credit.

Now when you have that kind of a fiscal policy, I don't see how in the world you can describe that as anti-inflationary.

Mr. FELDSTEIN. I think the primary driving force in interest rates and inflation has been the monetary policy that is pursued in the past. And I think the principal thing that is bringing rates down—these are 30-year bonds that we're talking about—the principal thing that is bringing those rates down is the growing feeling that inflation has been fundamentally checked, that this process that was driving the inflation rate from, as I said in my statement, 2 percent in the 1960's to more than 12 percent in 1979 and 1980——

Senator PROXMIRE. Well, now, I wouldn't dispute that. I think there's no question that inflation has come down. But I think it's come down partly because of the recession, and certainly because of a monetary policy which has been very restrained, but hardly in harness with the fiscal policy, which seems to be going the opposite way.

We've had the Chairman of the Federal Reserve Board, Paul Volcker, and we've had other chairmen come before us and constantly insist that there's no way they can have a monetary policy that's going to work to fight inflation effectively in the long run, as long as Congress is running these enormous deficits.

Now you seem to be telling us that fiscal policy somehow is coordinated with monetary policy. That certainly is a surprise to the Federal Reserve Board.

Mr. FELDSTEIN. I think the deficits are a bad thing. I think the deficits are keeping real interest rates, but not market interest rates, up. I think that the problems that we face in this country are multiple. If we had only one single goal—to bring down the interest rate—we could focus all of our policy tools on that. But we have several goals. And I think that the current tax policies of the administration and Congress that were passed in 1981, particularly the prosavings and proinvestment policies, are focusing on a long-term problem of increasing capital formation.

Senator PROXMIRE. Now you've said that social security, you said this—"fortunately"—I'm quoting you. "Fortunately, social security is in such a financial mess, the problems are so severe, that serious financial reform cannot be avoided in the next few years."

Why the use of "fortunate"?

Mr. FELDSTEIN. Because I think the problems in social security are not just the financing problems of the next 18 to 36 months. I think there is a long-run problem. As you know, when the demographics change, when the baby boom generation reaches retirement age, the draw upon the social security fund will be much, much higher as a fraction of income than it is today.

I think that the pressure that is bringing the Nation to focus on these long-term problems is coming from the short-term financial problems. And I think it's very important that we deal with these long-term financial problems of the social security system.

Senator PROXMIRE. Well, you're implying, then, that you don't think we can afford to provide as much of our income for social security in the future as we are going to be driven to do. I call your attention to the fact——

Mr. FELDSTEIN. No, I'm not really saying that. I'm saying that we have to look at that long-term and decide what we want to do and

not let it come upon us by surprise as we approach the baby boom retirement years and discover that we haven't made adequate provision.

Senator PROXMIRE. But isn't it true that we provide less for social security than any European country, far less than the French or the British? And the Germans provide 9 percent of the gross national product; we provide 4.2 percent. The Swedes provide 10 percent of the gross national product for social security. Those economies are in better shape than ours—less unemployment, less inflation, lower interest rates.

Mr. FELDSTEIN. The Europeans use the word "social security" very differently from the way we do.

Senator PROXMIRE. Well, I asked the Social Security Administration themselves to give me a comparison and that's what they provided.

Mr. FELDSTEIN. I can't comment on the numbers. I don't really know. But I would just say that the Europeans use the word "social security" to include things which are clearly outside the public system here, like health benefits that are provided privately by workers here that are included in the public sector in the countries that you mentioned.

Senator PROXMIRE. Let me just ask one other question because I appreciate the fact that the time is fleeting. You said in response to a question in 1981 about what the state of the economy would be in 1982 and 1983, and I quote: "Now all the good news is going to come in 1982 and 1983." You went on to say: "I'm not so sure about that. I don't see what the basis for it is. Monetary policy is going to remain tight. Housing is going to continue to be in trouble. Europe is not going to provide support. Government spending is declining. Consumer expenditures are not going to be increased by tax cuts."

That's all good news. You said, "That's all good news, from my point of view. It doesn't exactly lead to a buoyant economy."

Now why is all that good news? In my view, and it seems to me, in the view of most people who hope and pray for prosperity and a return to a healthy economy, that this would all be bad news.

Mr. FELDSTEIN. Well, I think we all want a recovery. I think we all want a recovery that will be sustained. We all want a recovery that will be noninflationary.

If I remember, that statement was made in the context of worrying about the possibility of one of these bounce-back recoveries in which we have a very rapid, but short run, increase in demand, fuelled by excessive monetary expansion, which hurts us in the long run, not only by creating more inflation, but by bringing the recovery to an early end.

So it really needs to be understood, Senator, as saying what I want is a sound recovery rather than an excessive one.

Senator PROXMIRE. Well, finally, Mr. Feldstein, this last question. I was going to ask you whether you thought you could establish a closer position and a more influential position with the President than Dr. Weidenbaum did. And I like Murray very much. I think he's a fine economist and a fine man. I think he did a good job under the circumstances. But he did not have as much influence with the President, in the view of many people, as past chairmen of the Council of Economic Advisers have had.

I was going to say I hope that you can establish a closer, more influential position. But in view of your position on social security, in view of your position on housing, in view of your position on the fiscal policy, I hope that your position is somewhat less influential than Mr. Weidenbaum [Laughter.]

Mr. FELDSTEIN. That's one hope we don't share [Laughter.]

The Chairman. Senator Dodd?

Senator DODD. Thank you, Mr. Chairman.

Mr. Feldstein, I join with my colleagues here in welcoming you to the committee and in congratulating you on your nomination. I, too, would want you to know that any questions I may ask are more directed at trying to determine your policy. Like Senator Proxmire, I commend you for your background academically, and your obvious knowledge of the field of economics. It's more a question of specific policy considerations that goes to the temper of these questions.

Have you had an opportunity yet to speak directly with the President about your views?

Mr. FELDSTEIN. Yes. I've seen the President. I've been down here for about two weeks and during that time I've probably met with the President five or six times.

Senator DODD. Has the President probed you about your specific ideas as to what suggestions you might be making to the administration?

Mr. FELDSTEIN. We're going to have a meeting tomorrow of the Cabinet Council on Economic Affairs and currently, I expect that the President is going to be at that. I will have a substantial period of time to describe in detail my views about both the longer term and the shorter term for him.

Senator DODD. But I presume that you have already had at least some discussion about your views.

Mr. FELDSTEIN. We have had some discussion, yes.

Senator DODD. Have you made some suggestions to the President as to things that you would like to see him do in the coming calendar year?

Mr. FELDSTEIN. I think it's really inappropriate for me to talk in more detail about the nature of my discussions with the President.

Senator DODD. Well, I'd like to—it's difficult to ask you the question of whether or not you've agreed with certain policies because you're about to enter a policy position, or whether or not—and I won't violate the confidential relationship that you sense you have with the President.

So I'd like to sort of get a sense of your personal views. I just wanted to be aware of whether or not the President was aware of some of your views. That's really all I was driving at.

We recently had a tax increase bill that was proposed by the President to the Congress. Did you support the President's tax increase bill?

Mr. FELDSTEIN. I thought that the package of trying to control the growth of the deficit by a combination of the tax increase and the spending cuts that were part of what I understand to be the agreement with the Congress were a worthwhile package, yes.

Senator DODD. So you thought that that was a worthwhile package. Your predecessor, Mr. Weidenbaum, has made suggestions in

his capacity now as a private citizen that we needed to make some cuts in the defense budget.

Do you agree with him?

Mr. FELDSTEIN. I have not yet examined the defense part of the budget. I think I really have to reserve judgment until I have had a chance to examine in more detail the defense part of the budget. It's not an area of my own expertise ——

Senator DODD. I'm not asking you about specific programming now. I recognize that that will take some analysis. But as a general economic proposition, recognizing the President has proposed that we increase defense spending by $250 billion over 5 years, is it your view, in light of our efforts to reduce spending, do you think it is wise, given our present level of deficits, the projected level of deficits, that as a general proposition we reduce defense spending? Yes or no.

Mr. FELDSTEIN. I think we have to look at it as part of the whole budget process. But I don't want to prejudge at this point whether the President and his advisers have set in light of future events an inappropriate or appropriate level of defense spending. I think I really have to look at that.

Senator DODD. We've spent roughly $30 billion in housing subsidy programs prior to the Reagan administration coming to office. We have reduced the spending in the housing areas to roughly $10 billion. Do you believe that we can make further cuts in Federal support for housing?

Mr. FELDSTEIN. You're asking me a program question that I just can't answer. I just don't know the facts about that program yet. I am the new boy on this block, having arrived just after Labor Day and I don't know the details of those programs.

Senator DODD. You don't know whether or not we can make further cuts in housing? I thought you already suggested the possibility.

Mr. FELDSTEIN. No specific Federal programs.

Senator DODD. Well, do you think we can make further cuts in the Federal commitment to housing?

Mr. FELDSTEIN. Well, what I said before in answer to Senator Riegle and Senator Proxmire is that I think we should have more capital formation. If we have more capital formation, it will go into housing as well as into plant and equipment. And I think one form of Federal commitment, as I indicated before, is to reexamine some of the barriers to more creative mortgage instruments that deal more adequately with the problem of the young prospective housebuyer who sees his income rising, but who is forced to put up an extremely larger share of his current income in order to buy the kind of house that he wants for the longer term.

Senator DODD. Have you expressed the opinion that a way of increasing revenues would be to eliminate the interest deduction on mortgages?

Mr. FELDSTEIN. No, I have never done that.

Senator DODD. Do you think we should?

Mr. FELDSTEIN. No. Well, my feeling is that to do that precipitously would be very disruptive, that people have taken out mortgages, purchased homes, with the understanding that they're going to have that deduction. If the deduction were removed this year,

people would not only lose their current deduction, but they would take very large capital losses in the value of their houses.

So I have never suggested that change.

Senator DODD. And you would oppose any such move?

Mr. FELDSTEIN. I don't know what evidence I would see in the future. But if you would ask me now on the basis of what I now know, I would oppose doing it now.

Senator DODD. And the way you phrased your response, you seem to indicate that for present homeowners. Are you suggesting somehow for future homeowners, that we ought to have a different—grandfathering in or something of that nature?

Mr. FELDSTEIN. No, I think that that would have a similarly adverse effect. it would have a doubly adverse effect. People would stay locked into homes which were inappropriate for them in order to take advantage of the grandfathering. They also would know that the value of their houses had fallen sharply, because when they tried to sell them to a new buyer, that new buyer, not having the tax advantage of the deduction, would be not willing to pay nearly as much for the same physical house.

So I would think that any kind of precipitous change on that would be very unfair and going back on promises that have implicitly been made to people when they acquired those homes and those mortgages.

Senator DODD. And a gradual change as well would be unwise.

Mr. FELDSTEIN. If it's gradual enough so that the effect is imperceptibly small, then it's a more reasonable policy. And if it were to ever be done, I think it would have to be done in a way that was so gradual, that the capitalized losses in the value of homes was extremely small. Otherwise, I think it would be backing down on what I think is an implicit commitment.

Senator DODD. But it is your position today that you will not make such a recommendation to the President?

Mr. FELDSTEIN. If asked now, I would not make that recommendation.

Senator DODD. You've got a very distinguished background, as has been pointed out by everyone here on the committee, and you're a distinguished scholar and professor. You've obviously had a chance to, I'm sure, at least think about it, if not comment on it yourself. What are your views of a constitutional amendment to balance the budget?

Mr. FELDSTEIN. Well, as I look at that, it clearly is representative of a very strong feeling on the part of the public that they want to see budgets balanced. They want to see deficits reduced. They want to see Government spending brought down.

We see that in the administration's proposal. We see it in the proposal that has been made by the Democrats in the House. Then with that as a background, the question is how to do it?

Senator DODD. Correct.

Mr. FELDSTEIN. I don't think that's an economic question. As I think about that, I realize that's a question where designing the right procedure to control spending is not something that I come to Washington with any particular expertise on.

Senator DODD. Well, it doesn't appear this year that we're going to—the House will not take up the issue of the constitutional

amendment to balance the budget before we adjourn. And so the effect of the Senate action this year will have to be repeated.

Will you recommend to the President that he submit or that he support a constitutional amendment? We're talking about putting economic policy into the Constitution of the United States. That's the issue. Will you make such a recommendation that we revive that debate again next year in the Congress?

Mr. FELDSTEIN. I would recommend to the President that we work toward reducing the size of our deficit. But I would claim that as an economist, I neither can answer the constitutional law question, whether it's an appropriate part of the constitution, nor——

Senator DODD. You don't have a view on whether or not that was a good idea?

Mr. FELDSTEIN. I don't have a professional view on that at all.

Senator DODD. What's your personal view?

Mr. FELDSTEIN. I really don't have an informed view on that question.

Senator DODD. I won't tell anybody. [Laughter.]

Mr. FELDSTEIN. I just don't have a view on that subject.

Senator DODD. You don't have a view on whether or not we ought to have a constitutional amendment to balance the budget?

Mr. FELDSTEIN. Whether that is the right way—I don't have a view that's worthy of consideration on the question of whether that's the right way to achieve what we all want to achieve. And I'm going to let somebody more expert than I——

Senator DODD. You're going to be the Chairman of the Council of Economic Advisers.

Mr. FELDSTEIN. And if asked about questions of law, I'll have to pass.

Senator DODD. Well, what about the notion, the economic impact of suggesting to people that we're going to balance their budget because we've written it into the Constitution? Now clearly, there are going to be economic ramifications of that action, as a result of the political decision to try to put it into the Constitution.

Now as the Chairman of the Council of Economic Advisers, you must have a view on whether or not that is a sound piece or a sound step to take, considering the overall economic implications.

Mr. FELDSTEIN. I think that a credible, accurate forecast that says we're going to change our fiscal policies to shrink our deficits over the next half dozen years or sooner to a balanced budget is a desirable achievement.

Senator DODD. I totally agree with you. I'm not going to have any debate with you on that.

Mr. FELDSTEIN. Now, is it wrong, then, for the administration to say that we're going to strengthen the ability, the resolve of ourselves and the Congress to do that by a balanced budget?

I think that as far as the specific question you're asking, not the legal question, not whether it's good as a procedure for Congress, the economic impact will simply be to reinforce the public's view that Congress and the administration mean business about bringing down the deficit.

If it has that effect, then I would say it's a good thing if that's what we really aim to do.

Senator DODD. My time has expired. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Feldstein, I'm sure you're a big boy and although you haven't been involved in politics before, you recognize that most of the questions today, you are a symbol and they are being directed at you because you are here. But they go far beyond you to the administration. It is an election year and there's no doubt about that. I could take a lot of time to talk about 25 years of a Democratic Congress.

I suppose as the father of seven, I've got both you and the Senator outnumbered considerably, and that I have some concerns about people's ability to buy homes and their economic condition.

I think there is no disagreement on the difficulties of this economy—the high unemployment rate, high inflation rate we have experienced, the still far too high interest rates.

But I suppose I get a little bit frustrated when I have to listen to either side, either those who would try and place the entire blame for the condition of this economy on previous Democratic Congressmen, Congresses, or this administration, because I don't believe that either extreme usefully serves the purpose of trying to solve the problem. There's enough blame to go along for everybody, for Democrats and Republicans, administrations of both parties, Congressmen and Senators of both parties, for a long, long time.

In other words, we're in a hell of a mess. Partisan politics either way—it gets a little bit distasteful to me. We ought to be trying to work together for a solution. To indicate that Ronald Reagan has caused all of this problem in 20 months is an insult to my intelligence or that somebody else did it, Jimmy Carter did it for 4 years, or whatever.

I wish it were possible to focus more on solutions, look at the arithmetic of these budgets and see what has happened. It's not a matter of Republicans or Democrats; it's a matter of we spent $100 billion to run this country, total $106 billion, 20 years ago in 1962. John Kennedy was President. And now we're going to spend $800 billion. And we're going to spend $125 billion plus for interest on the national debt. And we're not going to have $150 billion this year. But John Kennedy ran the whole country and defended it 20 years ago for $106 billion.

Incredible. And that's arithmetic. That isn't Republicans or Democrats. It's simply arithmetic. It's simply factual. It's factual what you said—nobody's got the guts to discuss social security. But there's built-in problems. Republican, Democrat, liberal or conservative, if we don't have the guts to face it, some future Congress long after we're gone is going to inherit a problem that makes today's look like nothing.

I wish it were possible to address the arithmetic and the facts. I wish it were possible to discuss the defense budget on the basis of the threat rather than just the dollars. I wish it were possible for people to realize that John Kennedy in that budget spent 48 percent of that $106 billion on defense and nobody bitched then. It was all right. John Kennedy was doing it.

Now Reagan is going to 28 or 29, maybe, if he gets this vast military budget, and that's way too high. The numbers again. If you want to look at the numbers of the military budget in real terms, they're virtually the same for the last 20 years, or 30 years.

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Look at the 1955 budget—about $42 billion. I wish it were possible for this Congress to forget who are Republicans and Democrats and liberals and conservatives and start trying to solve the problem instead of looking for political advantage. And I don't mean to indicate and I don't want anybody to think here that my remarks are directed at Senator Riegle today. They're not. [Laughter.]

He and I are friends and he knows what I'm talking about. He's heard me long enough condemn the whole Congress, regardless of what party they belong to. So it isn't directed at him or any other individual.

The only other comment I would make——

Senator RIEGLE. Whether you realize it or not, he means what he just said. He was just making an honest statement.

The CHAIRMAN. In any event, let me make one other comment in response to your net worth. The one thing in Senator Riegle's questioning that I don't really understand the point of particularly is whether we're all supposed to, any nominee for anything in any administration is supposed to be poor, that being financially successful is some hindrance to being appointed to something.

If we use that criteria, we could get rid of about a third of the Senate right off the bat because they've been too successful.

The other point I would make about net worth is—mine startles me. You know, I've never really made very much money. And mine is probably in the neighborhood of a half million or $600,000 because I own two houses. No other reason. I bought one for here right down the street from Don Riegle's house. You know, I paid $100,000 for it. Now it's worth $250,000. I couldn't even qualify for it today. So there's $150,000 of equity. Man, I'm rich. It doesn't help pay the taxes on it. It doesn't send my kids to school. Man, I'm rich, paperwise.

I've got a half million bucks. If I did away with that half million bucks, it wouldn't change my standard of living at all. It's all on paper and it's all because of inflation, every darn dime of it.

My father probably never had a net worth of more than $25,000, just as much as mine. It was all in his house out here. It becomes rather meaningless. So I don't know whether you can spend your million dollars or not. I can't spend my half million at all. It isn't there to spend. It's just paper.

So I don't know. I'm sorry you're not worth more. You haven't been very successful, really. [Laughter.]

Because any fool in an inflationary society who bought a house has got a pretty big net worth. So I don't consider that a real problem because you've got a million bucks. You probably can't spend it any better than I can.

Well, I'm through with my question period. We'll go to Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

I don't want to dwell on that earlier point except to make this observation with respect to what the chairman has just said. I don't think the absolute level of a person's net worth is by itself the key point. The question is whether this administration has become topheavy with millionaires and multimillionaires and whether there goes with that what one can see and feel in policies

an insensitivity to problems that are bearing down very severely on average citizens in this country.

I can tell you that increasingly across my State of Michigan, people are being so severely harmed by unemployment, by the other difficulties of the recession, and many of the policies, the actual policies of this administration, national spending priorities among them, that they increasingly are coming to the view that the policies are being designed to help somebody else and not help them. As a matter of fact, people at the very top levels of income in this country are doing very well under these policies. I think there's a growing feeling that perhaps the policies are sort of stacked, whether consciously or unconsciously, in favor of people who are in those categories, in the millionaire and multimillionaire category.

You can see it in the way the tax cut was given out a year ago. You see it in a lot of other policies.

So that's the issue here, the sensitivity issue. Perhaps you'll bring a sensitivity that's different and that can help bend these policies in a way that is fairer in terms of the broad impact across the society. I hope so. They need to be made fairer than they are today.

But let me go to a specific that gives me great concern. We talked about housing before. You're on record as saying that you think we're overhoused. I happen to strongly disagree. I think we're underhoused and the problem is getting worse.

But you have also made some very strong statements about social security. And I think as much as anything, your nomination may come down to a referendum on the question of what's going to be done to the social security system and whether or not we're going to keep it intact as is, looking out into the future, or whether we're going to continue the major surgery that the Reagan administration has already started.

Now when you testified before the hearings of the Joint Economic Committee in 1981, you said several things that I find really disturbing. You make several observations. I'm just going to quote from your written statement which is in this record and which I'm sure you're familiar with.

You talk about the problems of social security and you say: "The primary reason for these financial problems is the unprecedented explosion of social security benefits in the last decade." And having then set that stage about what you describe as the explosion in benefits—and by the way, I would disagree with that description, certainly in any real income sense—you go on to say that there has to be a slowing of the growth of the benefits and that you think that the proposals for doing so have generally been "far too timid."

That's a direct quote. I'm sure you recognize it.

You go on to say that you favor an immediate start to slowing the growth of benefits. And then you go right after the COLA adjustment, which we have in the system to try to adjust the benefits to keep pace with the increase in the cost of living. It's not a real gain for people; it was established to try to keep benefits even with inflation so that recipients are not caught with a social security benefit that buys less and less, when people pay their utility bills

or their heating bills or pay for prescription drugs or for food or what have you.

And then you introduce a new concept, and that is that you propose cutting back on the cost-of-living benefit in the future. And you give an illustration here where you say that if the inflation rate were to rise 8 percent, that the retiree's benefits would rise by 6 percent. This is spoken to here as something you call a 2-percent floor. I believe that's the phrase you use. But the idea is, that if the cost of living goes up a certain amount, the social security adjustment should not increase equally. It should go up less by 2 percentage points.

This is a very fundamental question and a question lies right at the heart of much of the debate that's gone on here about social security because more and more people depend on social security and many of these people don't have private pensions, and don't have net worths that approach yours or the chairman's or the members of this committee. I'm talking about people who are at certain levels of modest circumstance. They rely on social security payments. And if, in fact, they fall behind the inflation rate, they have no other way to keep up. There is no other place to turn to get money. If you're in retirement, you're often not employable, even if there were jobs to be found and, as a matter of fact, there aren't any jobs to be found right now. We have 11 million people looking for them and not finding them.

You go on in this vein and you also talk here about lengthening the retirement age as well. Haven't you also spoken out about that?

Mr. FELDSTEIN. I can't remember whether I did in that testimony.

Senator RIEGLE. But you have in other areas, have you not?

Mr. FELDSTEIN. Yes.

Senator RIEGLE. And have you suggested one possibility here being lengthening the retirement age so that social security benefits would not start at 65, but start at a later age?

Mr. FELDSTEIN. I certainly have in the past said that that is one of the ways that we could think about changing the social security rules, as more and more people retire later and live longer.

Senator RIEGLE. Did you support the administration's proposal to eliminate the minimum benefit under social security?

Mr. FELDSTEIN. I never took a position on it one way or the other.

Senator RIEGLE. You're sure of that?

Mr. FELDSTEIN. I believe I have never taken a position on that one way or the other.

Senator RIEGLE. Are you familiar with the minimum benefit?

Mr. FELDSTEIN. Yes, I am.

Senator RIEGLE. It's the $122 a month payment, and so forth.

Mr. FELDSTEIN. Right.

Senator RIEGLE. We had a great fight about that here, as you know.

Mr. FELDSTEIN. I remember that.

Senator RIEGLE. Did you take a position on the President's proposal to reduce the early retirement benefit by 40 percent?

Mr. FELDSTEIN. I don't believe I took a position on it.

Senator RIEGLE. That was highly controversial. We eventually defeated that here.

Mr. FELDSTEIN. My feeling is that—well, let me go back to your earlier statement about what's happened to benefits in the past. Between about 1970 and the current time, benefits to social security recipients have increased in real terms about 50 percent. During that same period, real earnings for the worker have remained unchanged. So there's been a very, very substantial shift which I think was largely unintended. It came about in part because of the double indexing error that was recognized and ultimately changed. It came about because the consumer price index was used rather than a more appropriate measure. And it came about because decisions were made back in 1972 to increase benefits substantially.

Senator RIEGLE. Well, let me just ask you this. Do you know offhand what the average person on social security would be receiving or what the median benefit level would be for a person now collecting social security benefits under the system?

Mr. FELDSTEIN. No, I don't know that number offhand.

Senator RIEGLE. Would you guess that the figure is about $500 a month or below?

Mr. FELDSTEIN. I think if you took the average benefit for all people——

Senator RIEGLE. No, no. We're talking about the median. We're talking about half the people would have a median benefit below that level and half above.

Mr. FELDSTEIN. Saying what about the treatment of husbands and wives? Each person counted separately?

Senator RIEGLE. Well, either way you like.

Mr. FELDSTEIN. I think the figure you have in mind is the one that looks at them each separately and includes people of all ages and I think it's a bit under $500 a month.

Senator RIEGLE. Pardon?

Mr. FELDSTEIN. A bit under $500 a month.

Senator RIEGLE. It is under $500 a month, and I don't think it's that close to $500.

Mr. FELDSTEIN. $450 or something like that.

Senator RIEGLE. I can't cite the number from memory. But that figure today as monthly income, and a very large number of people on social security have no other source of income—I mean, the private pension system in this country is a rather recent development. It does not cover that many people. Do you have any idea what people getting $450 a month, or people who are getting $300 a month, $275, $125, or even less than that, do to make ends meet? Do you know how far that goes today?

I don't know what your utility bills are. I assume your home is in Cambridge and so you're in a northern climate. I don't know what you're paying—do you know what your monthly utility would have been in the worst month of last year?

Mr. FELDSTEIN. I do not.

Senator RIEGLE. Would you want to take a guess?

Mr. FELDSTEIN. I wouldn't. [Laughter.]

Senator RIEGLE. Well, let me ask you to do something. That worries me as an answer because it seems to me, and I'm serious about

it. If the person who is going to head the Council of Economic Advisers doesn't know what his own utility bill is, he probably doesn't have an idea of what other people are paying. And I don't say it to you unkindly, but it's an important fact.

And let me tell you what the people in Michigan are paying and what you, in fact, may be paying, whether you know it or not. And that is, in the dead of winter, you may well be paying $300, $350, $400 or more a month just for your utilities.

That, to me, is a shocking fact. And, as a matter of fact, if you lay that against a median social security income payment of, say, $450 a month here, I mean, there goes the whole payment for one item. That doesn't include food. It doesn't include clothing, housing expense, transportation expense, or prescription drugs.

Mr. FELDSTEIN. Whenever I hear figures about the size of social security benefits ——

Senator RIEGLE. But here is my point. My point is that I think the notion is in the minds of some that somehow social security is a bonanza and that there are people out there getting these benefits that they don't deserve. They're getting benefits that aren't affordable—that the country has reached a point where we're forced to make major cutbacks in the social security system.

And I would say to you, and whatever predisposition you bring into this room, that if that's your notion, I think it's a mistaken notion. I think that this is a critical program. It has broad public support. It provides modest benefits to people who need that income. They have worked and they're earned the benefits. And they ought to be able to depend on them.

And if, in fact, your intention, as the Chairman of the Economic Advisers, is to advocate slicing into the system and cutting it back, cutting down on cost of living increases or stretching out the retirement age, or in other way cutting down benefits then I don't think you're the right person for the job. There's a new scheme loose now to apply a means test on medicare just floated in the last 2 days. I don't know whether you're familiar with it, whether you're part of it, how you would feel about it. But if you're bringing a perception that we have to take a knife to the social security system in the ways that you've described here and possibly other ways, then as I've said, I don't think you're the right person for the job. I don't think that's what the country wants today. And if those are your views, I would ask you—I think you need to—to really focus again on that issue, because if you're coming in here to represent the whole country, you're not just here as an employee of Ronald Reagan. In fact, he doesn't pay your salary. The citizens of this country pay your salary and as a public official, that's who you'll be working for, albeit, within this administration.

I think the people of the country want the social security system and the future benefits that are now in the law and which they expect will be coming to them. They want them protected and they want them maintained.

And I would hope that you would feel that you could be an advocate in protecting that stream of future income for people who depend upon it and not slice it apart in the ways you recommended in your earlier statements.

Mr. FELDSTEIN. Let me say that I don't come in as an advocate for either side. I don't come in with a precommitment to any particular solution to the kinds of fundamental problems that I think we agree the social security system has to deal with.

But I don't come in with a view that I am going to advocate a particular solution. I think my job is to present the President with a range of alternative views and analysis of those views.

Senator RIEGLE. Well, I hope that means that you are willing to not push these recommendations that you have made in this committee hearing. And I ask that your previous testimony be made a part of the record because we ought to have in here the detail of what we've been talking about (see p. 45).

But I would hope that you would not undertake to push these notions as national policy or in terms of an approach that the administration might take to start slicing more deeply into social security in the future here.

The CHAIRMAN. Dr. Feldstein, totally apart from the overall budget problems, is it not the case that in social security there is an issue of solvency, and that the most important obligation that we have to those on social security is to make certain that they continue to get their pensions and also that those who are currently paying into the system can expect to have a pension system in existence when they reach retirement age?

It seems to me that totally apart from the budget, that we have an issue of solvency. I don't disagree with anything that Senator Riegle has said about the problems of the elderly. I experienced it with my own mother depending on social security and 40 percent of her total social security going to pay the property taxes on a home that had been paid for since 1937, due to the increasing costs of local government.

So I understand the problem. And that's why I must emphasize the solvency issue. And also, I know of no one who is advocating cutting or taking the knife to social security, either in or out of the administration or in or out of Congress, but talking about slowing the growth.

Isn't it true that there are only two choices—the way the system is going purely from an arithmetical situation, from an actuarial situation, that you're either going to have to slow the growth or raise the taxes dramatically to pay for it, one or the other. There are no other choices, are there?

Mr. FELDSTEIN. You do have to get more net revenue into the system. It either means more taxes or it means a slowing down in the growth of benefits. Absolutely.

The CHAIRMAN. And so Congress will have to face up to one of those choices.

Mr. FELDSTEIN. But I think you're absolutely right in saying that no one is talking about cutting existing benefits.

The CHAIRMAN. Well, let me use an example that I have used several times because I happened to be in a city giving a speech a few weeks ago and was trying to explain this in a TV interview. I didn't seem to be able to get my point across, so I did this in the TV camera and that got their attention and stopped the cameras, and I said, now let me explain something to you and see if you understand the point I'm trying to make. And then if you want to

grind up your camera again, be my guest. If you don't, that's fine. Nobody votes for me in Georgia, anyway, so I really don't care. [Laughter.]

And I said, suppose you think you're the best TV reporter that ever existed and you demand a $10,000 raise. And you go to your employer and he says, you know, you really are good and you deserve $10,000. There's no doubt about it. But our advertising revenues haven't been that good and I can't afford it, but I will give you a $6000 raise. Would it be fair for you to go home and tell your wife that your lousy boss just cut your pay by $4,000?

He said, of course not. I got a $6,000 raise. That's all anybody is talking about to help solve the solvency issue—slowing the growth of future increases. I am an advocate that they continue to get increases, but we simply have to face up to the problem that there is a solvency issue. And af either side plays politics with social security, that is the worst demagoguery of all. There are two choices—raise the taxes, and they've gone from 1 percent of the first $3,000 base or $30 from the employee to the employer to now about $3,000 a year. And many of the people that are the most disadvantaged are paying no income taxes, but are paying sizable social security taxes that take one heck of a bite out of their low incomes to pay for that.

So it's true, we have simply got to either face the fact that there is a growing gap, totally apart from all this other rhetoric about budget and defense and everything else, social security by itself, you've got to either change those benefit levels as far as increases—not cut—or dramatically increase taxes. And then I wonder what the majority of people who are not high income, who are not terribly wealthy, like you and I, are able to pay for in the form of these dramatically increased taxes.

So I wish Congress would face up to that. I understand that your wife is also an accomplished economist. So I would assume that maybe Bill Proxmire would enjoy the fact that are we getting two economists for the price of one? [Laughter.]

Mr. FELDSTEIN. You are.

The CHAIRMAN. We would expect some advice at home at night from your wife.

I have no additional questions. Are there any questions that you know of from your side?

[No response.]

Dr. Feldstein, we appreciate your testimony today, and if you have no further comments, this portion of the hearing would be over and we would ask the National Association of Home Builders to come forward.

Mr. FELDSTEIN. Thank you very much.

The CHAIRMAN. Thank you very much.

Mr. Napolitano, we are happy to welcome you here today. This is the first time that we've seen you at a confirmation hearing. We have had lots of discussions and meetings in your capacity as the president of the National Association of Home Builders and the association before this committee in our normal housing hearings and things of that nature. But we are happy to welcome you before the committee today for this purpose.

STATEMENT OF FRED NAPOLITANO, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, ACCOMPANIED BY ROBERT D. BANNISTER, SENIOR STAFF VICE PRESIDENT

Mr. NAPOLITANO. Thank you, Mr. Chairman. My name is Fred Napolitano and I am a builder from Virginia Beach, Va. I am the president of the National Association of Home Builders. Here with me today is Bob Bannister, the senior staff vice president of the NAHB.

Mr. Chairman, as you know, I represent 108,000 members of the National Association of Home Builders. I am sorry to say that since November of 1981, we have gone down 13 percent from 124,000 to the present 108,000 members.

It is very uncommon for the president of a trade association to appear at a nomination hearing in opposition to a Presidential nominee for a major political position. My staff tells me that I am probably the first to do this. But I think it is compelling that I do so.

Also, on a personal note, I was down at the board of directors meeting that our association is having at the present time in Florida and I was compelled, not only by my own feelings, but that of my executive committee and my national representatives—who come from all over the country—to appear here today on their behalf to talk about this nomination. Obviously, we're here to oppose the nomination of Dr. Martin Feldstein as Chairman of the Council of Economic Advisers.

Now I want to make sure that everybody understands that I'm not here to challenge his credentials, either professional or academic. I just met Dr. Feldstein a moment ago. I shook hands with him and wished him luck, even though I'm here to oppose his nomination.

I don't know the man. I've never met him before and I don't know about his technical competence for this high office. I am concerned about his views regarding housing and the economy, his basic philosophy of the administration's economic program, and in particular, his view on housing and how it affects the people of this country who need housing very desperately.

Now I need not go into detail before this committee about the depressed state of the housing industry. The current recession is the most prolonged and devastating of the seven downturns since World War II. Total housing production for 1981 was 1.1 million, the lowest annually since 1946. For the first 8 months of 1982, housing starts have run at levels that are 25 percent below the comparable period in 1981. This year should end with production even below last year's record-setting low level. In fact, any improvement in housing production this year has been the result of pushing Government-assisted units into the pipeline, especially in the multifamily sector. Single-family starts will not improve substantially, if at all, this year. Construction unemployment in August exceeded 20 percent with more than 1 million skilled craftsmen out of work.

To put that into some historical perspective, last year we produced housing at a rate of 4.2 units per thousand population, in 1946 we produced 8 units per thousand. That level of production

does not bode well for the postwar baby boom generation moving into the housing market this decade.

I must add that in the last few weeks, we have begun to see the first signs of increased confidence among builders in the field. Interest rates have declined, and traffic has picked up at subdivisions in some parts of the country. But builders are very cautious, with good reason. And clearly, many parts of the country will see no upsurge in sales or construction because of the serious weakness of the economy and high unemployment.

Given this perspective and a fragile hope for a housing recovery, the nomination of Dr. Feldstein takes on a more ominous tone. In a speech before the American Paper Institute in October of 1981, Dr. Feldstein explained what he believes is the basic philosophy of the administration's new economic program and its impact on the national economy in the coming years. He observed that:

> Congress and the Administration have come to understand that the existing tax treatment of housing, especially the deductability of nominal interest payments and the essential absence of any capital gains tax, already provides too much of an incentive for investment in housing, relative to investment in plant and equipment.

He concluded that:

> The decline in residential construction that we are now experiencing in this country is therefore not merely a transitory response to high interest rates, but part of a substantial, long-term process.

In a statement as clear and unequivocal as any I have heard, Dr. Feldstein told his audience of paper and timber companies:

> The effect (of the administration policy) is therefore not a conflict between monetary and fiscal policies as we so often read in the press, but a coordinated mix designed to twist the composition of spending away from housing, away from consumer durables, and into plant and equipment.

Plant and equipment is what Dr. Feldstein later describes as "productive investment."

But in a question and answer period, Dr. Feldstein made an even more pointed statement on the limited role of housing and the economy. When asked, "Will housing never recover?," he replied:

> That's the right answer, I'm afraid. The gentleman said "never." I mean I think the normal level of the 1960s and early 1970s may not return. I think that as a nation we are overhoused because we have created a series of incentives and financial institutions designed to create that and that was explicit policy in the immediate post-war period.

He summed up, and I quote again, "Basically, I think the picture for housing is bleak." And in the short term for 1982, Dr. Feldstein took comfort in the fact that "housing is going to continue to be in trouble." As he said, "That's all good news from my point of view, but it doesn't exactly lead to a buoyant economy."

What he was saying, in essence, was that all the things the administration is doing and the fact that housing will be down and continue to be down, is, in his opinion, good news.

Mr. Chairman, as you know, I am not naive and I must admit that I have heard and read statements like this before. Those statements have appeared in articles in business magazines, editorials in the Wall Street Journal, and from some academics. But I have never heard an administration spokesman present this antihousing bias as a conscious and deliberate long-term administration policy. Maybe we've been led down the garden path. I don't know. Maybe

we've had our collective heads in the sand. But I was privileged to meet with the President in March of this year to discuss his views on housing. When one of our allied industry spokesmen asked the President whether his administration was accurately being perceived as being antihousing, the President looked shocked and responded immediately that nothing could be further from the truth.

Mr. Chairman, I am deeply troubled and somewhat confused. If the Feldstein statements represent the views of the administration, then I have a very significant statement to make to my board directors in Miami tomorrow. If these are Dr. Feldstein's personal views and the administration is prepared to disassociate itself from them, I will feel more encouraged. In either event, I believe that Dr. Feldstein's views do not represent a philosophy appropriate to the President's Chief Economic Adviser.

Mr. Chairman, I am certain that the views of Dr. Feldstein on housing do not represent the views of the members of this distinguished committee. Your task of disapproving this nomination is difficult, but I feel that these views are so antihousing that they would impair Dr. Feldstein's ability to provide advice to the President in the critical area of housing and economic policy.

Mr. Chairman, you are well aware of my views on restoring housing as a major national priority. Your support, and the unanimous support of this committee, for an emergency housing stimulus program earlier this year reflects your belief that housing must play a critical role in a sustained, long-term economic recovery. We must not pit housing against other productive investments in the economy.

When the President vetoed the stimulus bill, he said that he could not single out one industry for special relief. Now Dr. Feldstein has singled out the housing industry for his own brand of special treatment. And frankly, as an industry, we have had more than enough special treatment under the Federal Reserve Board's policies. Much more than we can endure. As the patient is beginning to show halting signs of recovery, we think that the Feldstein program of pulling the plug on the life support system cannot be more inappropriate and untimely.

Mr. Chairman, I am here to say that the reports of the death of the housing industry are greatly exaggerated. I have traveled around the country for the past 4 years. I have visited with many students on college campuses and young families seeking a decent place to live. With the exception of transportation which is a problem for college students today, as Senator Riegle is probably interested in, so they would like to have a car. But the two major concerns of these young people are, first, they are almost obsessed with the prospect of being able to get a decent job. And second, they are fearful that under the current conditions, they will not be able to afford even a modest place to live and raise a family in this great country of ours. And that is deeply troubling to these young people today. These are your children and my children that we're talking about.

No, I say to Dr. Feldstein, that they are not concerned about which brand and model of personal home computers or other nondurables that they are about to purchase. The dream of home ownership for the rich and poor has not died. Hopefully, it is only tem-

porarily deferred for the 41 million Americans who reach the prime homebuying age of 30 during this decade.

And Dr. Feldstein, I'm sure, knows, as I have been saying all year, that every administration and Congress since the 1930's recognized the social, political and economic benefits of a well-housed nation. As he has said, that was explicit policy in those years. Today, many of the underpinnings of that housing policy—including the specialized mortgage lending institutions—are being dismantled. But something must take their place.

We will continue to work with this committee, the Congress, and the administration to develop alternative mechanisms to assure an adequate supply of mortgage credit in the future and continue an explicit policy to provide decent, affordable housing through the private sector.

Mr. Chairman, unlike our many previous visits before this committee, I am not pleased to have to be here today. It is not easy or comfortable to testify against any person nominated to the highest level of government service. But I felt that it would be unfair to this committee for me as president of the National Association of Home Builders not to appear here today to express the views of the 108,000 homebuilders in this country, and to represent the millions of potential homebuyers who are looking to buy a home.

This nomination represents a most critical impact on housing.

Mr. Chairman, I would strongly urge that this committee review carefully the views of Dr. Feldstein on housing and the economy prior to considering his confirmation. During the course of those deliberations, I would hope that the President would think seriously about reconsidering this nomination at this time.

And as a final resort, it is with reluctance that I ask this committee to disapprove the nomination of Dr. Feldstein as Chairman of the Council of Economic Advisers.

I thank you for the opportunity to appear here. If I can, I'll be happy to answer any questions.

Senator PROXMIRE. President Napolitano, I want to thank you for an excellent statement and a statement which I'm sure, as you say, is extraordinarily difficult to arrive at.

It's very, very rare—unfortunately rare—for any group to come up and oppose the nomination of any President. It almost is never done. And I think that's too bad, because appointments are controversial. They should be debated. They should be discussed. The advise and consent requirement of the Constitution imposes a duty on us to consider seriously every nominee.

So in the 25 years that I've been on this committee, I can't remember an occasion offhand—there may have been two or three occasions when groups have come up to oppose a nominee, but there have been very, very few. I think that's a contribution on your part. We should know how people really feel about things. Most people say, well, he's going to be confirmed, anyway. The President's appointed him. We don't want to be in the doghouse with him or with the administration, so we'll go along.

But you haven't done that. You have done what your principles and your convictions have told you that you should do. I particularly like the last part of your statement where you indicate that you hope the President will withdraw the nominee. I think that this is

such a serious nomination, so controversial, that we should take considerable time in discussing this, before it reaches the floor and when it reaches the floor, so that the Members of the Senate are fully aware of the attitude of Mr. Feldstein.

I'd like to ask you, first, Mr. Feldstein explains his position as not antihousing, but procapital formation. He said that what we need is a larger pie of capital. He thinks that the housing share may be too big and the share should be reduced, but that the total amount that housing would get, as he explained, as you recall, could be bigger.

What's your reaction to that explanation? Does that satisfy you in any way?

Mr. NAPOLITANO. No, that doesn't satisfy me, Senator. I believe the first part of what he said to be accurate, that we need more capital in the country for all the things we want to do. But while we're limited in the dollars that we have to provide what is necessary in this country, I don't believe that we should be taking it away from housing. First of all, housing has gone down—this is our fourth year. We're coming close to 4 years of a downturn in housing, which has created tremendous shortages in parts of this country. Now in other parts of the country, there is too much housing because of the economy in that particular area.

But by the shortages that have been created, rents are increasing in many areas, the price of homes will go up as the interest rates begin to drop. We had a long discussion with Mr. Volcker about that. Inflation will take hold again. But I don't believe that if you take money away from housing and put it into other areas, we're going to have the production in this country that everybody claims we will. He talks about putting money into more productive areas as plants and equipment.

I would like to remind the Senator and the committee that the homebuilding industry is made up of about 3,000 different items that go into homes. These are all manufactured, for the most part, in some plant in this country. So plants and equipment, when you talk about that, is housing.

So, if you want to build up the economy, you must build up housing. The gypsum companies, the lumber mills, the roofing companies—these are all plants that we're talking about. This is the plant and equipment I assume we're talking about in this country, not just steel mills. That's not all we're talking about.

So if we want to build up plants and equipment, get housing moving again. Put money back into housing as a priority and the economy will begin to move, much more rapidly than it's moving at the present time.

Senator PROXMIRE. Well, it seems to me that he's exerting a value judgment, too, when he indicates that housing is less important than these other things. After all, why do we want productivity? Why do we want production in various areas? Because of the end product. Is housing less important than automobiles? Of course, automobiles, too, are hurt by the policies of high interest rates. But is housing less important than soft drinks? Is housing less important than entertainment?

I think, as was indicated here earlier, housing is right at the heart of the American dream. People devote more of their time and

attention and concern to their home than anything else, and they should. Furthermore, it has a very constructive, conservative influence, it seems to this Senator, on our people. If somebody owns their home, they have an entirely different attitude toward the neighborhood and I think an entirely different attitude toward the society than if they don't. They have a stake and I think that's something we should encourage.

We have the highest homeownership in this country, in proportion to our population, than any country in the world. That's something to be very proud of. It's something that you want to retain.

Let me ask you this. Mr. Feldstein also has stated in the past, and I quote:

> That, in essence, is what the administration's new strategy is doing. The effect is, therefore, not a conflict between monetary and fiscal policies, as we so often read in the press but a coordinated mix designed to twist the composition of spending away from housing, away from consumer durables, and into plant and equipment.

Now aside and apart from the wisdom of taking capital away, which is what he says he would do, the fact is that the pie has not gotten bigger and it's unlikely to get bigger, when we have a policy of the kind that we're pursuing in which interest rates are so high. You don't encourage capital formation under these circumstances.

Obviously, people are not investing more. They're investing less. We aren't getting a bigger pie. We're not making progress in this way, isn't that correct?

Mr. NAPOLITANO. That's correct. There's no question, I agree with his statement that we need more savings in this country. But, if you recall, I'm sure you know that people have saved traditionally to buy a home—the American dream. And they will save more when there's the ability for them to go out and buy that home.

From his statements, as I have analyzed them, he's saying that the administration is going in a certain direction that is taking money away from housing. Now this is his interpretation of it. Now if that is the case, then we're losing the American dream in this country. And he further goes on to say, and this is what concerns us the most, that he agrees with that philosophy, if that is, in a sense, the philosophy of the administration.

Now no one in the administration has come out and said that. And Dr. Feldstein—I must give him credit for this—at least is saying what he thinks at this point. Now if he is saying what the administration is saying, also, or thinking, then I think the administration should say that.

When I met with the President, he said that that was not the case.

Senator PROXMIRE. Well, I think the administration is sincere about that. I think that that's a unique position. I see that the chairman has returned. I do want to ask one other question. The question of whether we're overhoused came up. I thought you answered that pretty satisfactorily. But let's button it up as much as we can.

As you say, we have housing shortages, low vacancy rates. It's true that in some parts of the country, there are vacancies. Overall, with the very high interest rates that we've had, not only this year, but in 1980 and in previous years, we are considerably underhoused. There is a colossal demand out there. Isn't that correct for

housing? Don't we need more housing? Aren't people living doubled up? Aren't they unable to get the home that they need because they simply can't afford to pay the high interest rates?

Mr. NAPOLITANO. Senator, they're not only doubling up. They're tripling up in cases. And I now hear of cases where couples—these used to be singles before—where couples are buying homes together and sharing a common kitchen because they can't afford to buy a home by themselves, as small as it may be.

Yes, we do definitely have building shortages out there. Let me qualify something. When they talk about overhousing in this country—I have talked to many people about this who have taken the other side of it, and when you finally pin them down—what they're saying is, well, we build too many big houses.

Senator, I can tell you, and Mr. Chairman, that I have a big house right now. I built it when my children were growing up. They are all gone right now. What they're telling me is that I ought to take my house and maybe divide it up and put two other families in there with me. That's what they mean by overhoused. Not overhoused in the sense that everybody can get an affordable, decent home. And they're smaller. There's no question about it. We're going to smaller units these days. And still, there are shortages.

When they talk about being overhoused, they want us to open the big houses up and put other people in it, and then maybe we wouldn't have shortages.

Senator PROXMIRE. Thank you, sir. Thank you, Mr. Chairman.

The CHAIRMAN. I believe you solve that problem, Fred, as I do. As older children move out, I have new ones. [Laughter.]

Senator PROXMIRE. He isn't quite in the class with Strom Thurmond, but he's working on it.

The CHAIRMAN. Oh, I've got three more than Strom and I've still got 20 years to go before I'm as old as when he started his first one. So don't give up yet. [Laughter.]

Just one question. Wouldn't you agree that the principal problem of the housing industry, not just now, but we've talked about this many times, the ups and downs. This is the worst one you've been through in a long, long time, but there's been a lot of time. And at least in my opinion, the major problem has been Government taking capital out of the marketplace.

It seems to me it just about directly correlates because now you have Government borrowing this year more than 50 percent of all of the available capital. Forgetting whether Mr. Feldstein wants more in this type of capital than another, the available pool of capital has been remarkably reduced as a result of Government borrowing taking it away from any private sector investment.

It seems to me that housing cannot expect the kind of recovery that we would all like to see it have until we can reduce that level of Government borrowing taking that capital out of the private sector and competing for those funds. If you've got Government out borrowing more than 50 percent of the available capital at very high rates, as they have been the last 2 or 3 years particularly, obviously, it drives up the interest rates on the available capital that's left, producing a shortage of capital, whether it's for housing, machinery or anything else.

So I would hope that homebuilders would continue their positions of the past, that we do need a retrenchment of Government, that we've got to have some fiscal responsibility if we ever hope to get out of this very, very severe recession that we've got in the housing industry.

Mr. NAPOLITANO. We fully agree with you on that. There can be no debate on it. That's our primary objection with the entire country. But as it pertains to housing, while it is true that if we get the Government out of borrowing, interest rates might come down. As to what degree, we may have differences on that. I've heard anywhere from 4 to 7 points from different Congressmen and Senators and I don't see it coming down even with the tax increase, although it's come down gradually.

However, what concerns us about Dr. Feldstein and any person in his position, or that type of position—and the President is being surrounded by people who have the same philosophy—is that housing could go on the back burner and they would not worry about it for the next 3, 4, 5 years under that philosophy when all the problems with the interest rate and the budget and so forth are resolved, housing will get its share in the free marketplace. But we're not going to do anything to help housing. The American people are going to compete with everybody else for capital for housing.

And that's the philosophy that's prevailing right now. That's what's of great concern to us. If they would follow with up a statement, as you just said, and I know where you stand on it because you have been very helpful, along with this committee, but if they would follow up the statement that we must get the budget in line. We know housing is important to this country and we're going to do everything possible to see that it remains a high priority for the American people, we would feel more assured. If they said it and meant it. They're not saying it.

And as I said before, and you may have heard me, Dr. Feldstein was the only one I've heard, who has said that housing is going to take a backseat. No one else has actually said that, although there's a lot of indication of that.

The CHAIRMAN. Well, I understand. I understand the nature of your testimony. I simply wanted to, totally apart from the nomination hearings today, once again emphasize my feelings that we cannot solve the underlying problem unless we reduce that level of Government borrowing.

Mr. NAPOLITANO. I agree.

The CHAIRMAN. I understand what you're saying. There are other things that we can attempt to do. But the foundation of all of this—most of those are short term, and that's basically why I made the remark of your ups and downs in the homebuilding industry, I believe, is because we've never faced the underlying problem. And so we tinker. We have short-term solutions. It makes you better for a while and each crunch, though, seems to get deeper than the previous one.

And I'm just saying that, totally apart from these hearings today, I just want to emphasize once again that I think Congress has got to start tackling these underlying problems. Just like with social security. We can hide from it. We can try to put it off until after the election. Congress basically is not looking at the underly-

ing problems or willing to tackle them. So we do the piecemeal, short-term, emergency-type pieces of legislation.

Just like Senator Lugar's bill. I supported it and tried to help him get it through. You supported it. But I'm sure you would have to admit that that was another short-term solution that would have been helpful. I think it would have been helpful. It didn't do a thing to solve the underlying problem. That's the only point I was trying to make. I think we need to do much more.

Mr. NAPOLITANO. On that level, Senator, we agree. There's no question. Our association agrees.

The CHAIRMAN. We appreciate your willingness to testify, particularly to come from Florida, although if the convention were in Utah, it would have been even harder for you to leave. [Laughter.]

But we appreciate you being here today. Thank you very much.

Mr. NAPOLITANO. Thank you, sir.

The CHAIRMAN. The committee is adjourned.

(Whereupon, at 12:40 p.m., the hearing was adjourned.)

[Biographical material on the nominee and additional material received for the record follows:]

STATEMENT FOR COMPLETION BY PRESIDENTIAL NOMINEES

Name: Feldstein (LAST) Martin (FIRST) S. (OTHER)

Position to which nominated: Chairman, Council of Economic Advisers Date of nomination:

Date of birth: 25 November 1939 (DAY) (MONTH) (YEAR) Place of birth: New York, N.Y.

Marital status: Married Full name of spouse: Kathleen Foley Feldstein

Name and ages of children: Janet 10

Margaret 12

Education:

Institution	Dates attended	Degrees received	Dates of degrees
Harvard College	1957-61	A.B.	1961
Oxford University	1961-67	M.A.	1963
		B.Litt.	1963
		D.Phil.	1967

Honors and awards: List below all scholarships, fellowships, honorary degrees, military medals, honorary society memberships, and any other special recognitions for outstanding service or achievement.

Harvard National Scholarship; General Motors Scholarship; Fulbright Fellowship; Phi Beta Kappa; Member, Institute of Medicine of the National Academy of Sciences; Member, American Academy of Arts and Sciences; John Bates Clark Medal of The American Economic Association; Fellow, National Association of Business Economists

Memberships: List below all memberships and offices held in professional, fraternal, business, scholarly, civic, charitable and other organizations.

Organization	Office held (if any)	Dates
American Economic Association	Executive Committee	pre-1975 to current
Econometric Society	Council	Pre-1975 to current
Council on Foreign Relations	-	1980 to current
American Statistical Assoc.	-	pre-1975 to current
Royal Economic Society	-	pre-1975 to current
National Bureau of Economic Research, Inc.	Pres.,Director,Trustee of Pension Plan	1977 to 1982
Economic Studies, Inc.	Pres.,Director, Trustee of Pension Plan	1976 to 1982
Phoenix Mutual Life. Ins. Co.	Director	1977 to 1982
TRW, Inc.	Director	1981 to 1982

Employment record: List below all positions held since college, including the title or description of job, name of employment, location of work, and dates of inclusive employment.

Research fellow and then fellow, Nuffield College, Oxford, England, 1964-1967

Harvard University, Cambridge, Mass., Assistant Professor, 1967; Associate Professor, 1968; Professor 1969 to present

Economic Studies, Inc., Cambridge, MA., President 1976 to 1982

National Bureau of Economic Research, Cambridge, MA., President 1977 to 1982

Government experience: List any experience in or direct association with Federal, State, or local governments, including any advisory, consultative, honorary or other part-time service or positions.

Member, President's Commission on Productivity, 1981 to 1982

Published writings: List the titles, publishers and dates of books, articles, reports or other published materials you have written.

See attached list for scientific publication. I have also written columns for The Wall Street Journal, and, with my wife, for the Boston Globe and Los Angeles Times syndicate

Political affiliations and activities: List all memberships and offices held in and services rendered to all political parties or election committees during the last 10 years.

None. I do register in a political party to vote in the Massachusetts primaries.

Political contributions: Itemize all political contributions of $500 or more to any individual, campaign organization, political party, political action committee or similar entity during the last eight years and identify the specific amounts, dates, and names of the recipients.

None of $500. or more

Qualifications: State fully your qualifications to serve in the position to which you have been named.
(attach sheet)

See: Education; Employment Record; and Published Writings.

Future employment relationships:

1. Indicate whether you will sever all connections with your present employer, business firm, association or organization if you are confirmed by the Senate.

I will sever all connections with all employers except that I will be on leave from Harvard.

2. As far as can be foreseen, state whether you have any plans after completing government service to resume employment, affiliation or practice with your previous employer, business firm, association or organization.

None except with Harvard and Economic Studies, Inc. (the firm that my wife and I own)

3. Has anybody made you a commitment to a job after you leave government?

None except Harvard.

4. Do you expect to serve the full term for which you have been appointed?

There is no fixed term for this appointment

Potential conflicts of interest:

1. Describe any financial arrangements or deferred compensation agreements or other continuing dealings with business associates, clients or customers who will be affected by policies which you will influence in the position to which you have been nominated.

None

2. List any investments, obligations, liabilities, or other relationships which might involve potential conflicts of interest with the position to which you have been nominated.

None

3. Describe any business relationship, dealing or financial transaction (other than tax-paying) which you have had during the last 10 years with the Federal Government, whether for yourself, on behalf of a client, or acting as an agent, that might in any way constitute or result in a possible conflict of interest with the position to which you have been nominated.

None

4. List any lobbying activity during the past 10 years in which you have engaged for the purpose of directly or indirectly influencing the passage, defeat or modification of any legislation at the national level of government or affecting the administration and execution of national law or public policy.

None

5. Explain how you will resolve any potential conflict of interest that may be disclosed by your responses to the above items.

I see no current or potential conflicts of interest.

Civil, criminal and investigatory actions:

1. Give the full details of any civil or criminal proceeding in which you were a defendant or any inquiry or investigation by a Federal, State, or local agency in which you were the subject of the inquiry or investigation.

I was the defendant in a very small motor vehicle civil case.
The case was settled by the insurance company.

2. Give the full details of any proceeding, inquiry or investigation by any professional association including any bar association in which you were the subject of the proceeding, inquiry or investigation.

None.

POLICY FORUM

HOUSING—A PRIORITY TO PRESERVE THE AMERICAN DREAM

By Fred J. Napolitano
President
The National Association of Home Builders

"A partnership of government and industry transformed us from a nation of renters to homeowners."

My idea of progress has always been that we could pass on to our children and our children's children a better way of life.

During my lifetime, America has indeed been a very progressive society. Americans today are much better fed, educated, cared for and housed than they were when I entered the home building business some 30 years ago. Now here has this idea of progress been more evident than in the way we house our people.

Between the end of World War II and 1982, entrepreneurs built 55,356,000 new homes and apartment units, and rehabilitated and restored millions more. A partnership of government and industry transformed us from a nation of renters to homeowners. Two-thirds of all households now own their homes.

This didn't happen because of chance or some miracle in the free market. It happened because every Administration and every Congress since the 1930s recognized the social, political and economic benefits of a well housed nation. Housing was ranked as a top national priority. It enjoyed bipartisan support. What was good for housing was good for the country.

Since the 1930s, credit has been the lifeblood of the housing market. Our government helped shape a financial system that gave home buyers access to credit that made housing affordable. Specialized mortgage lending institutions were chartered. Interest rate ceilings were placed on savings accounts. Mortgage loans were insured and guaranteed. Taxpayers were allowed to deduct mortgage interest and property taxes.

Like cheap energy that kept America running on wheels, inexpensive mortgage credit fueled the nation's housing delivery system.

Just as the oil jolts of 1973 and 1979 brought an end to cheap energy, so did a combination of developments—ranging from savers who demanded higher returns, to inflation that raised the cost of all borrowed capital, to shifting government priorities—bring an end to the days of inexpensive mortgage credit.

Between 1978, the last good year for housing, and 1982, the cost of mortgage money doubled. As mortgage interest rates rose to 17%, the monthly payment on a $60,000 mortgage loan climbed to $855, requiring an annual income of close to $40,000 to qualify. The rest is history. Home sales plummeted, followed shortly thereafter by the deepest national recession in the postwar period. Housing starts fell to 1.1 million units last year, the lowest production level since 1946, and 1982 promises to be even worse. More than one million construction workers lost their jobs. Business bankruptcies rose to their highest levels since the Great Depression.

Where do we go from here? Do we repeal the opportunity of homeownership for 41 million Americans who will turn 30 this decade and enter the housing market?

Or does this crisis demand bold, bipartisan leadership and a spirit of cooperation between the President, the Congress and the Federal Reserve?

You don't have to be an economist to realize that high interest rates are strangling the economy, and that housing is caught in the crossfire between tight money and a fiscal policy that is too loose.

Bringing interest rates down requires some basic policy adjustments. First, the Federal Reserve must ease up on the monetary brakes to permit a lasting decline in interest rates. Secondly, the budget crisis must be resolved. Deficits totaling $500 billion over the next three years threaten to keep interest rates at record levels. To close this deficit, some taxes must be raised and additional spending cuts found in all areas of the budget.

By making these adjustments and synchronizing the nation's economic policies, interest rates will decline, confidence will be restored and economic conditions will improve.

Once the smoke clears, our elected leaders can begin the job of shaping a new financial system that will give all Americans access to mortgage credit at prices they can afford. That's the only way we can restore housing as a national priority, and by doing so, preserve the very idea of progress that has made this country great.

THE NATIONAL ASSOCIATION OF HOME BUILDERS

SPEECH BEFORE THE AMERICAN PAPER INSTITUTE, OCTOBER 1981

WHAT WILL THE REAGAN ECONOMIC POLICY DO?

(By Dr. Martin Feldstein, professor of economics, Harvard University, and president, the National Bureau of Economic Research)

I want to talk this morning about the revolution that has begun to occur in economic policy in this country. I think it represents a reversal of the mistakes of economic policy of the past two decades, a reversal that's likely to have a profound effect on the national economy and on all of our individual lives. The errors and excesses of economic policy in the 1960s produced the poor economic performance we've come to know in the 1970s. High inflation, low capital formation, declining productivity growth, and a growing share of income going in government spending and taxes. If you think back to the early 1960s, the overall inflation rate then was only 2½ percent a year. By the beginning of 1970s, it was 5 percent and by the end of the 1970s, it had reached 10 percent. Indeed, in 1979, the CPI jumped 13 percent. The combination of inflation and high effective tax rates reduced the returns to saving and investment and caused a sharp fall in capital formation. Shared GNP devoted to net investment in plant and equipment plummeted 40 percent between the second half of the 1960s and the second half of the 1970s. This low rate of capital formation limits the rise in productivity, lowers the rate of economic growth. Indeed the annual rate of productivity growth halved, between the 1960s and the 1970s, and output per employee actually fell in 1973 and 1974.

But all the while, the government continued to grow, taking a larger share of national output and financing that growth by a combination of deficits that crowd out private investment and higher taxes that reduced private incentives. Government outlays rose from 18 percent of GNP in 1960 to 20 percent in 1970, 22 percent in 1980. And this 25 percent growth in government's share would have been greater, indeed much greater, if the share of GNP going to defense had not been halved over the same period. Government's non-defense outlays actually rose 9 percent of GNP in 1960 to 17 percent in 1980, doubling in two decades. The government deficit averaged less than 1 percent of GNP in the first half of the 1960s but took more than 2½ percent of GNP in the second half of the 1970s and the combination of income and payroll taxes last year took 55 cents out of every extra dollar earned by a couple with $40,000 of income. Took only 35 percent per dollar from a couple with the same relative income 20 years earlier. Thus the marginal tax rate that governs incentives rose by 50 percent for individuals in this group.

That combination, rising inflation, declining capital formation, falling productivity, doesn't reflect any inherent weakness in the American economy. Rather a poor performance was the result of the well meaning but misguided economic policies established in Washington in the naively idealistic days of the 1960s and then pursued with such gusto in the 1970s. The dramatic changes, in tax rules and monetary and fiscal policies that are now taking place can do much to end the poor performance of the past decade but I think much more needs to be done to make the new approach effective in achieving its well chosen levels.

GOOD POLICY, BAD DESCRIPTION

Unfortunately though, the nature of the new economic policy has been poorly explained by the Administration. The public at large, the business community in particular, have been rightly distrustful of the combination of some supply side hyperbole and the abstract rational expectations theory that they're heard from the Administration and its friends. These irrelevant pieces of economic rhetoric together with the plausibly optimistic forecasts of rapid growth and vanishing deficits have created a credibility gap that will make it more difficult to slow inflation and that now threatens to undermine Congressional support for continuation of the Administration's programs. This morning, therefore, I'd like to try to explain what I believe is the basic economics of the Administration's program and to look at the impact that I think it's going to have on the American economy in the coming years.

To understand that program, it's important to recognize how the low rate of capital formation and its sharp decline over the past decades played a central role in shaping both the tax bill and the macroeconomic policies that the Administration is pursuing. The extent of our capital formation problem has long been misunderstood and this misunderstanding has led to a complacency that until last year blocked any serious reform. That complacency was often based on the fact that for the past two decades, the United States saved and invested about 15 percent of GNP. Fifteen percent of GNP is about three-forths of the average in the major and industrial

countries of the OACD. And the rate of 15 percent doesn't seem unreasonably low for an affluent, relatively mature economy. Certainly any family that devotes 15 percent of its income to savings is doing a reasonable job of providing for the future. But those figures and that type of reasoning are totaly misleading. An analysis that I did as part of an NBR study showed that although 15 percent of GNP has been devoted to investment during the past 20 years, three-fifths of that investment has been needed just to replace the capital stock that's wearing out. Only 6 percent of GNP has therefore been left to increase the net capital stock, the net investment. This 6 percent net investment rate is less than half of the average among the major industrial countries of the world. To make matters worse, half of that 6 percent in this country goes into housing and inventories, leaving only 3 percent of GNP for net investment in plant and equipment. Even that poor record of the past two decades has been getting worse. A very low rate of net investment in plant and equipment dropped to only 2½ percent of GNP in the last half of 1970. Forty percent below its level a decade earlier. Our low rate of capital formation means that we as a nation, are passing up the opportunity to earn a high rate of return and thus to raise our future standard of living. Additions to the stock of plant and equipment earn a real return before tax but after adjusting for inflation of about 11 percent. Thus by giving up a dollar's worth of consumption today, we can in effect have 11 cents a year for the indefinite future. Or put it differently, by giving up a dollar today, we can have 2 dollars worth of consumption at today's prices in just 6 or 7 years.

This rate of return is at least as high and probably higher than the rates of return available on new investments in other countries of the industrial world. Why then, do we have such a low rate of saving and investment? Our low rate of capital formation really reflects a whole range of government policies that impact every aspect of economic life. Tax rules that penalize saving and discourage business investment. A Social Security program that makes saving virtually unnecessary to the majority of the population. Credit market rules that encourage large mortgages and extensive consumer credit while limiting the rate of return available to the small savers. And perennial government deficits that absorb private savings and thereby shrink the resources available for investment.

KEYNESIAN ROOTS IN FORMER POLICY

Each of these four types of policies that discourage investment and saving in this country can be traced ultimately to the Keynesian fear of savings that has so permeated the economic thinking and economic policies in this country for the past 40 years. As you may recall, Keynes argued that the Depression of the 1930s was due to inadequate spending or equivalently to excessive savings. The implication of this theory was clear. Develop explicit policies that discourage savings and encourage consumer spending. This theory designed for the British economy in the depths of the Depression of the 1930s came to have a powerful and inappropriate impact on the economic policies of this country and of Britain in the 1950s, 1960s and 1970s.

In other Industrial countries of the world, Keynes intellectual influence was much weaker and the possibility of a new Depression caused by excessive saving seemed a much smaller problem than the urgent need to rebuild their capital stocks after World War II.

As a result, the countries of Europe and Japan developed policies that were designed to encourage saving while the United States and Britain developed policies to discourage saving. The impact of this whole array of policies has been more powerful than the sum of its separate effects of policies taken alone. By its combination of anti-saving policies and pronouncements, our government has created an anti-saving attitude among the present generation of Americans. In effect, while the French or German or Japanese governments have been telling their citizens in both words and in policies, more saving would create capital for better jobs, our government was induced by this outmoded Keynesian fear of saving to tell the American public that saving less and spending more on American made consumer goods was the key to higher employment. Unfortunately, this combination of adverse incentives and misguided cajoling were so successful that the United States and Britain have had the lowest saving rate in the industrial world during the past two decades. A crucial feature, then, of the new economic policy is to reject completely the Keynesian fear of savings and to reconcile and to recognize that a higher saving rate would be a good thing for the American economy.

THE NEW FISCAL POLICY

The 1981 tax legislation was signed in August and provides clear evidence of such a change in thinking and of the strong bipartisan support that now exists for policies to encourage capital formation. There were no fewer than 6 major changes in personal tax rules aimed at encouraging individuals to save more. I believe that these tax changes will gradually increase the rate of saving in the economy. I don't agree with the critics, cynics, who claim that the expanded IRA provisions, for example, and the other rules will simply induce individuals to transfer assets from one type of account to another in order to claim the tax advantage. The studies that we've done at the National Bureau indicate that 75 percent of families in this country have only enough financial assets to take advantage of the new IRA option for less than two years without doing additional saving. After two years, they'll have to do more new net saving in order to take advantage of the new tax benefits.

The business part of the tax bill, as you know, concentrated on offsetting the rise and the effect of tax rates on corporate source income. During the past 15 years, the rising rate of inflation and the tax accounting methods used for inventories and depreciation have caused the effective tax rate on income from corporate capital to rise sharply, despite the occasional statutory reductions in corporate rates, statutory improvements and depreciations. In the mid 1960s, nonfinancial corporations, shareholders, the creditors, paid a combined tax rate to governments at all levels of 55 percent. Fifty-five percent of real profit directly measured, taken in taxes in the mid 1960s. By the second half of the 1970s, that tax share had jumped from 55 percent to 68 percent. Back where it had been in the early 1950s, before accelerated depreciation, before the investment tax credit. With the tax bite rising from 55 percent to 60 percent, the share that was left for those who provided capital fell from 45 percent to only 32 percent. A decline of merely one-third. The real after tax rate of return to those who provide debt and equity capital was thus only 3 percent by the late 1970s. Surely not enough to provide an adequate incentive for saving and risk taking. This 3 percent return represented a 40 percent decline from its level a decade before. Not at all surprising, therefore, that the net investment in plant and equipment in American corporations, also fell by 40 percent over that 10-year period.

The tax bill provides a dramatic reduction, more so than most people realize, in the tax rates on new investment and therefore will apply higher net rates of return. The combination of a five year life, accelerated depreciation and the ITC are enough to offset the use of historic cost of depreciation for most types of equipment investment. The more advantageous, the 15 year life for structures and particularly the new equipment leasing rules just add to the attractiveness of these changes. When the new tax rules are fully phased in, the effective tax rates should be down from the recent 68 percent to somewhere between 55 percent and 60 percent. It's range during the investment boom of the 1960s. And as firms switch more and more from FIFO inventory accounting to LIFO accounting, the effective tax rate will fall even further. Its particularly significant that virtually nothing was done in the tax bill for residential investment. This reflects a deliberate decision. Congress and the Administration have come to understand that the existing tax treatment of housing, especially the deductibility of nominal interest payments and the essential absence of any capital gains tax, already provide too much of an incentive for an investment in housing, relative to investment in plant and equipment. Housing stock now accounts for half of all fixed capital in the United States and the share of housing and investment has also been rising in recent years in response to the greater advantage of deductible interest payments in a period of inflation. The ratio of net investment and residential capital to other forms of net investment in plant and equipment rose from 50 percent at the end of the 60s to 75 percent a decade later.

Congress and the Administration wanted to reverse this and see more of total investment channeled into plant and equipment. The decline in residential construction that we're now experiencing in this country is therefore not merely a transitory response to high interest rates, but part of a substantial long term process.

NEW MONETARY TIGHTNESS

This brings me to the broader subject of a new macroeconomic strategy of fiscal and monetary policies. As I said when I began my remarks, new strategy has been explained very badly and is still widely misunderstood, even in financial and business circles. I think that the Administration's basic approach represents sound economics but it's been wrapped in voodoo rhetoric. The danger is that the public and the Congress will judge the package by its wrappings and that this will weaken its chance for success. To understand the new approach, it's useful to contrast it with

the old strategy that guided macro economic policy since the early 1960s. The aim of the old strategy was to combine easy money, designed to encourage investment with tight fiscal policy, designed to prevent inflation. Easy money was interpreted as low interests rates and tight fiscal policy meant balanced budgets or even surpluses. That strategy clearly failed. In the attempt to keep interest rates low, Federal Reserve kept increasing the money supply which in turn just produced more and more inflation. Fiscal tightness was never achieved. The budget was never in balance for two years in a row and showed a deficit in every year in the 1970s. Moreover, because of the tax laws, the old strategy completely backfired by producing inflation and actually reduced investment in plant and equipment while encouraging more resources to go into consumer durables and housing. This occurred, as I indicated a moment ago, because higher rates of inflation increased the advantage of deducting nominal mortgage interest and simultaneously exacerbated the problems of historic cost depreciation.

The Administration's new strategy completely reverses the roles of monetary and fiscal policy. The monetary authorities, the Federal Reserve, will now disregard the role of increasing investment and will focus instead on achieving the low inflation rate. Fiscal policy in turn will ignore the problems of inflation but will focus on stimulating savings and investment by a combination of low budget deficit and targeted investment incentives.

One result of the new strategy that we can expect for the remainder of the 1980s and beyond, is that interest rates, after adjusting for inflation, will remain high. These high real interest rates will discourage all kinds of capital intensive spending, including business investment, housing, and consumer durables. But the more liberal depreciation rules will offset this higher cost of capital and provide a net stimulus to business investment. No such tax changes will offset the higher cost of funds for housing, or for consumer durables.

That, in essence, is what the Administration's new strategy is doing. The effect is therefore not a conflict between monetary and fiscal policies as we so often read in the press, but a coordinated mix designed to twist the composition of spending away from housing, away from consumer durables, and into plant and equipment.

NO REAL TAX CUT

Where do the reductions in the personal tax rates fit into this strategy? Won't they simply stimulated consumption? Aren't they going to be inflationary? The answer in short, is no. Despite all the rhetoric about the big tax cut, there will in reality be no reduction in tax rate. The much touted 25 percent reduction will be just about enough to offset the bracket creep that would otherwise push taxpayers into higher brackets.

Now, there will of course, be a tax cut for this relatively small group currently paying tax rates of more than 50 percent on investment income. But the loss in revenue from that change is trivially small, about $3 billion out of total tax revenue of $600 billion. For most taxpayers, there will be essentially no tax change unless the individual's real income also changes. The basic arithmetic of this rather surprising conclusion is easy enough to understand. Because of the graduated so-called progresssive structure of tax rates, 1 percent increase in all personal incomes raises tax revenues by not just 1 percent but 1.6 percent. The combination of inflation and real economic growth is likely to push up money incomes by about 10 percent a year for the next several years. A 10 percent in income leads to about a 16 percent increase in tax revenues. Therefore the government can give back 6 percent and still have the same ratio of tax to income. Six percent a year for the four years of the tax cut, so-called, is 24 percent and that's just a reduction that the Administration has promised before indexing begins. As a result, there will be essentially no reduction for most tax payers, small reduction at the top, small increase at the bottom, but very little change at all in the middle.

The Administration has never explained this to the public. Its rhetoric was designed instead to sell the tax bill as a major tax cut. Indeed, the original extreme form of wishful thinking that Reagan used as a candidate called for cuts in personal taxes without any reductions in government spending. In reality, what we're seeing are reductions in government spending without any cuts in personal tax rates. But because the Administration never explained that there are essentially no personal rate cuts, its critics have been able to charge that its fiscal policy is irresponsibly inflationary. In fact, the personal tax changes are part of a basically deflationary package of fiscal and monetary policies. Unfortunately, instead of explaining this, the Administration tried to stretch our credulousness by claiming that a major tax cut would not be inflationary because it would unlease a powerful supply side re-

sponse, that would cause workers to work more, investors to invest more, and that this in the short run would increase output by enough to offset the increase in demand.

Since there is essentially no tax cut to be offset, it doesn't really matter that the likely supply response is much weaker than anything the Administration claimed. Indeed, since most tax payers will see their marginal tax rates remain constant or change by only one or two percentage points, there's no reason to expect any significant supply response from them. The Administration also tried to argue that its major tax cuts would not be inflationary because the tax reductions would be mostly saved. Many of you will have noticed how Doonesbury disposed of that argument in one of his cartoons. But again, the reality that for almost everyone, there is no tax cut to either spend or save.

Unfortunately though, the Administration's combination and plausible forecasts and unbelievable explanations has led to an unwarranted fear of an inflationary series of tax cuts. People are still only slowly beginning to see that this is not true, that the Adminstration's propram is really a sound one, hiding behind a bad description. Many forecasters still speak of an increased demand for consumer goods that will result in the next couple of years from the major tax reductions. In fact, the reductions in tax rates are, as I said, basically only enough to offset bracket creep and therefore can't lead to any spurt of consumer spending.

REAL SPENDING CUTS

In contrast, though, the Administration's spending cuts are real; despite the increase in the defense budget. This represents a sharp reversal of trend toward higher spending in recent years. As I noted a couple of moments ago, government outlays rose from 20 percent of GNP in 1970 to 22 percent in 1980. Increased annual rate of spending that in today's budget terms amounts to $60 billion a year. This rapid growth was especially strong in recent years, with federal outlays rising 17 percent between 1979 and 1980, and then another 14 percent between 1980 and 1981. In contrast though, the outlays for 1982 now look like they'll rise by only about 3 percent. Since GNP will probably rise by more than 3 percent, we're actually going to see a decline in the share of GNP going to government spending. It's important, moreover, to realize that the legislative changes that have achieved this important turnaround will continue to reduce government spending in future years. Indeed, the slowdown in government spending reflects changes in programs like food stamps, housing subsidies, CETA, that will automatically accomplish even larger reductions in the future without more congressional action.

There are those who say that there is no more scope for reducing outlays, that all the fat is gone and that the remaining domestic programs are vitally necessary. In reality, I think there is great scope for further reductions in outlays to trim back the near doubling of non-defense spending as a percentage of GNP that's occurred in the past two decades. Indeed, just returning non-defense spending to the same share of GNP that it had in 1970, would reduce federal outlays in 1984 by $160 billion. I'm not predicting that such substantial reductions will occur that quickly, I'm merely pointing out how much scope of budget cutting there is without reducing the level of public services or benefits below the relatively high levels of 1970, the year that came after the explosive 1960s growth of Great Society programs. Where will these budget cuts occur? Revenue sharing that transfers money through Washington back to states and localities. In federal matching programs that distort local decision making. The Medicare and Medicaid programs that inflate the cost of medical care for everyone. And a variety of welfare type programs that provide inappropriate benefits to middle income families for such things as school lunch subsidies and food stamps and so on. And although the Administration's poorly designed proposal to reduce Social Security benefits for new retirees has temporarily made Social Security a politically hypersensitive taboo area, I believe that a way will be found to slow the growth of Social Security, thereby providing substantial reductions in future government outlays.

Indeed, in the past decade, real Social Security benefits per recipient, has jumped more than 50% while real earnings per employee in the economy have been virtually unchanged. This unprecedented increase in relative size of Social Security benefits, unplanned, unintended, and unwarranted, nevertheless, accounts for $45 billion of this year's $140 billion outlay for Social Security. These increased benefits are largely an unexpected windfall to current retirees. A slow down in the growth of benefits would be appropriate. Moreover, because high Social Security benefits reduce private saving and private pension accumulation, slowing the growth of benefits would increase capital formation as well as reducing government outlays.

Fortunately, Social Security is in such a financial mess, the problems are so severe, that serious financial reform cannot be avoided in the next few years.

More generally, the 1980s will provide Congress with the opportunity and the financial incentives to reduce the share of national income devoted to government spending. That process has already begun. It's important to recognize the deflationary effect of these reductions in spending. Many people, when I talk, ask me, are the spending cuts big enough to offset the reductions in personal taxes? That's the wrong question. Since there will in reality be no personal tax cut, there is nothing to offset. The spending cuts are a net deflationary factor that will contribute to a lower level of demand and will thereby help to reduce the inflationary pressure on the economy. We are, however, beginning the 1980s with a substantial government deficit. Even without any net tax cut, spending will have to be reduced rapidly by nearly 2 percent a year in real terms, to eliminate the deficit by 1984 as the Administration has proposed. I think Congress will not act that quickly and the drop in the government's interest cost will not be as rapid as the Administration forecasts. As a result, we are more likely to see a $50 billion deficit in 1984 than the balanced budget that the Administration continues to forecast.

IMPACT OF DEFICITS

The prospect of a deficit has come to be the focus of attention in Congress and in the daily press. Just what is its significance for the economy, for inflation, and for interest rates?

Since the government defict means that the Government must borrow more, the natural consequence of a deficit is a rise in the real interest rates on all debt. During the 60s and 70s, the Fed repeatedly tried to prevent this rise by increasing the money supply. Of course, the rapid increase in the money supply meant that on balance there was excess demand in the economy and this in turn led to higher and higher rates of inflation. These days, fortunately, the Fed is taking a much stricter stand against excessive growth in money supply. But since the Fed's relatively restrictive policy is only two years old, many people, especially in the financial community, are afraid it won't last. They fear that the increasingly large government deficits in future years will lure the Fed back to its old accommodation policy of trying to limit the rise in interest rates. They know that if that happens, we'll have more of the same inflationary pressures that we came to expect in the 70s. I don't think that will happen. Although I believe the Fed will avoid its mistakes of the 1960s and 1970s, a continued series of government deficits is definitely bad news for the economy. When the government borrows to finance its deficits, it absorbs savings that would otherwise be available for productive investments in plant and equipment.

By competing for funds with private borrowers, the government forces up the real cost of funds and thereby crowds out private investment. It is this reduction, in private capital formation, that is the primary reason for opposing continued deficits. As I noted earlier, real net investment in the economy is only about 6 percent of GNP. Since the $50 billion deficit in 1984 would amount to somewhat more than 1 percent of that year's GNP, such a diversion of savings into the purchase of government debt would represent a substantial pool in the amount of resources available for real plant and equipment investments.

By emphasizing the direct capital deformation effect of a deficit, I don't mean to deny that deficits may contribute to inflation. Deficits may tempt the Fed to a more expansionist policy. This is certainly not inevitable to bring down the rate of growth of the money supply. And deficits can directly feed demand and therefore raise prices, at least until extra demand is choked off by rising interest rates.

DEFICITS AND INFLATION

But the casual link between deficits and inflation is really very weak. There's certainly no basis for the panicked fear of inflationary deficits, now being expressed by some financial investors and members of Congress. It's useful to put these numbers in some prospective. The most pessimistic estimates now put the 1984 deficit at about $100 billion. Although these amounts are large relative to investments, they're small as a percentage of total GNP which in 1984 will be about $4,000 billion. Indeed a $50 billion deficit in 1984 would represent a substantial decline in the relative size of the deficit from its current level. And the current deficit has not prevented the growing weakness of the economy. There is falling capacity utilization, and a gradual declining of inflation from about 10 percent last year to about 8 percent or so that we can expect for next year.

Frankly, it's impossible for economists to predict whether a $50 billion deficit will be too much or too little addition to aggregate demand in 1984. That depends on the level of savings, demand for housing, the demand for exports. Indeed, there's no difference between a balanced budget with the current savings rate and an $80 billion deficit if the savings rate should raise by 3 percentage points back to where it was in the mid 1970s. There are just too many uncertainties about the individual components of demand to predict what the effect of a $50 billion deficit would be. To put it bluntly, a $50 billion deficit in 1984 is well within the rounding area of forecasting that year's GNP of about $400 billion. Even among those who recognize this, there are those who worry about the impact on financial markets of the government's sale of $50 billion of additional debt. Fifty billion sounds like a much bigger problem than it really is. The $50 billion would really represent about 10 percent of total funds raised in U.S. credit markets, and the 90 percent would come from private borrowers, householders and business. That 10 percent would also be substantially less than the 20 percent share that the government has taken in the past half dozen years.

In short, while a $50 billion government deficit in 1984 would represent a substantial reduction in potential capital formation, it need not have a significant effect on inflation or on capital markets.

THE DEFICIT AS A SYMBOL

Why then are both the Administration and the Congress screaming so much about inflationary deficits? The Administration's goal is to reduce the growth of government spending. They understand that failure to do so means a reduction of capital formation, new set of tax increases, or both. But that's very hard to explain to the general public. The goal of reducing the government's share of GNP from 22 percent to 20 percent is just not a cause around which the public will rally, for which the public will support cuts in food stamps or school lunches or medicaid benefits. In contrast, the goal of preventing inflation by balancing the budget is such a cause. There is a certain magic sounding quality about a zero deficit as a goal, that is totally lacking when it's stated as a 1 percentage point reduction in government share of GNP. So the Administration is trying to rouse public support for its spending cuts with shrill warnings that a failure to do so will lead to ever increasing inflation.

The Administration's liberal opponents in Congress and in the press, have also found it convenient to claim that deficits will be widly inflationary. They don't want to see government spending reduced. But like the Administration, they also believe that the slow down of future taxes implied by this summer's tax bill will force reductions in government spending programs. They therefore want to undo part of the tax bill in order to permit personal taxes to increase rapidly in 1983 and beyond. And so the old big spenders now pose as the new prophets of fiscal rectitude, sternly warning us about the inflationary character of future deficits in order to develop public support for further tax increases.

THE FINANCIAL MARKETS

Unfortunately, all of this political rhetoric has simply frightened financial markets; pushing up interest rates and depressing share prices. In my judgment, interest rates, share prices, have overreacted. As market participants begin to understand better the reality of the situation, long term rates will decline and share prices will rise. But even if the deficits were not being exaggerated, other forces would keep interest rates high by historic standards. The high short term interest rates are the direct results of the Fed's very tight monetary policies. The Fed has adjusted its money growth market for this year down to 3¾ percent and promises an even lower money growth rate in 1982. Since GNP at current prices will rise about 10 percent this year, each dollar of the money supply will have to finance a 6 percent larger volume of transactions. To induce people, businesses, to economize on money balances in this way, short term interest rates must remain very high. Only if the level of economic activity declines significantly in 1982, will short term interest rates return to their single digit levels.

Long term interest rates remain high for a combination of quite different reasons. The primary reason of course is the continuing fear of inflation. Even if deficits don't raise the inflation rate, a continuation of existing inflation rates must be reflected in relatively high interest rates. Since the money managers who buy bonds have been burned by premature optimism so many times in recent years, they're reluctant to bid up on prices, bid down interest rates, until they're really convinced that inflation has ended.

The recent tax changes have also had the effect of permitting firms to pay higher interest rates on the funds that they borrow. Thus even when the expected inflation rate falls, real long term interest rates are going to remain high by historic standards. Nevertheless, the gradual decline in actual inflation and in expected future inflation, will bring long term interest rates back down from the very high current levels.

LONG-TERM OPTIMISM, SHORT-TERM PAIN

My remarks today certainly can be described as optimistic. I believe that the new approach to economic policy can reduce inflation and interest rates while raising capital formation and productivity. Unfortunately, however, the transition from our poor current situation to this better economic performance cannot be painless. Unemployment rates must rise, industries must suffer, profit declines and the current beneficiaries of government programs must feel the effects of reduced government spending. There is the danger that the adversities of the transition will be the undoing of the entire long term program. Congress now has a crucial role. If Congress doesn't look beyond the short term hard times . . . it could revert to its old ways and call for a Keynesian stimulus to demands. Government spending would rise and the Fed would be forced to increase the growth of credit. The result would be a return to accelerating inflation. Fortunately, I see no significant indication of Congress moving in this direction.

The other and more palpable risk is that Congress will not be willing to legislate enough reductions in government spending. With the future growth of tax revenues severely limited by the 1981 Tax Act, a continued rapid growth of government spending will result in deficits that absorb a larger and larger share of national income. This in turn would reduce capital formation, raise interest rates, and would increase pressure for greater inflation. But despite these risks, I do remain optimistic. I believe that in the 1960s and 1970s, the American people and our representatives, Congress, learned some painful but very important lessons. The result, I think, will be better economic policies in the 1980s and therefore better economic performance in the years ahead.

I'll conclude on that optimistic note and invite your questions about anything I've said, or for that matter, anything I didn't say. [Applause.]

So we have some time for questions.

Question. What do you think of Arthur Laffer's call for a return to the gold standard?

Answer. I think there are very few economists who share Art Laffer's view about the return to the gold standard. We might return to a very watered down thing that would be called the gold standard but that wouldn't make either the gold buffs or the monetarists happy. I think that a return to gold would do virtually nothing to dampen inflation or inflationary expectations because basically, the role that gold plays is to guarantee the business community, the public, that the government is going to slow the growth of money, is going to achieve a lower quantity, rather than a higher quality of money and that in turn rests on the belief that they won't undo or go off the gold standard. Once you've gone off the gold standard, as we have, there's no way to convince people that's an inviolable rule and therefore, when a crunch comes, the Administration will stay with its new policy. I don't think that's an out. I think that the continued successful performance of the Fed in bringing down the growth of the money supply and the gradual decline in actual inflation, or what will change people's attitude, rather than the adoption of some new magic rules for gold.

Question. What about the European economies?

Answer. Well, they have come to have, in recent years, more and more an impact on our economy but it's a relatively small one. There's no question that their economies are also turning soft at the same time and that we can't look to export demands to turn around the current slow down. I think that's a good thing because I think it is from that slow down that we will achieve reductions in inflation.

Question. Do you really think Congress has the will to stay on the present course?

Answer. I've spent a fair amount of time talking to people in Congress of both parties. I've been very impressed over the last four years at how their views have changed. Now, of course, they changed rapidly and in the right direction over those four years, they could turn back. But I think we saw it in the tax bill. A year ago I would have predicted that we would have had many of the changes that actually occurred in that tax bill but not all of them. I was surprised that they moved as rapidly and in as bipartisan a way as they did towards undoing the mischief that inflation had done to business taxation. And toward introducing savings incentives.

Maybe I'm too optimistic and maybe we will see a poor performance but my sense from continuing contact with people there is that they do see inflation as the key problem. I don't think unemployment rates are going to go to double digit levels. If they did get up to 12 percent, I wouldn't want to predict what Congress or even the Administration would do. But allowing the unemployment rate to rise from its current 7½ percent to 8½, 9 percent, I think Congress would tolerate that if we were making continuous progress on the inflation front. Moreover, I think we will see a variety of small changes in market incentives which will allow the labor markets to be slack without registering 8½, 9, 9½ percent unemployment rates. Very subtle change that occurred October 1 was the sharp reduction in long term unemployment insurance benefits, reducing from 39 to 26 weeks. A lot of people who were previously counted as unemployed will not be counted as unemployed now. Some of them will go back and find jobs. Some of them will drop out of the labor force. They won't show up in the official statistics as unemployed. I think if the Administration's programs that are currently being developed to deal with problems of youth unemployment, manage to bring down the unemployment rate in that group by a few percentage points (after all, they account for half of the unemployment in the economy) the political character of unemployment will be diffused. I am optimistic but I think with some basis.

Question. What do you see in the economy in 1982?

Answer. I think longer than most forecasts. You look at the forecasts from the association of business economists, you look at the standard corporate forecasts for 1982, they show a substantial increase in output. Until recently they showed a turnaround in the third quarter of this year and then it got moved forward to the fourth quarter of this year. Now all the good news is going to come in 1982 and 1983. I'm not so sure about that. I don't see what the basis for it is. Monetary policy is going to remain tight. Housing is going to continue to be in trouble. Europe is not going to provide support. Government spending is declining. Consumer expenditures are not going to be increased by tax cuts. That's all good news from my point of view but it doesn't exactly lead to a buoyant economy.

Question. Will housing never recover?

Answer. That's the right answer, I'm afraid. The gentleman said "never." I mean I think the "normal" level of the 1960s and early 1970s may not return. I think that as a nation we're overhoused because we have created a series of incentives and financial institutions designed to create that and that was explicit policy in the immediate post war period. The combination of tax deductibility, and regulation that kept down the interest rates to small savers so that mortgage borrowers could do better, are now not going to have the same bite that they did in the past. The relative returns on investment in plant and equipment will be better. I think housing has to be pulled up by general growth of the economy because I think its overall share in investment and in GNP and in the capital stock will actually decline over the 1980s.

The trouble with any kind of a switch of that sort in which a capital stock is out of proportion where it belongs, is that the correction is very sharp and we're seeing that now with a vengeance. It is possible that congress will do more than wait for interest rates to fall. I don't think they can really do anything to bring down mortgage interest rates. It's hard to believe they can realistically ask Congress to sweeten the tax treatment of owner occupied housing. I think innovations in the mortgage market, such as a move towards graduated payment mortgages, where individuals don't have to bear the brunt of the full currently 17 or 18 percent mortgage rate in the first years of repayment, may make for some increase in housing demand. But basically I think the picture for housing is bleak.

Question. Does the Federal Reserve really have the tools to effectively control the availability of money supply today?

Answer. Yes. They don't have the tools for controlling it week by week, day by day. Some of the extreme monetarists seem to care about whether MIB from one week to the other rises at an annual rate of this or that. But they've definitely shown that they can bring down the rate of growth of the money supply. They promised to bring it down into a range around 3-5 percent. They successfully brought it down and you have to remember that only a couple of years ago it was 10 percent so there's no question about the Fed's ability by high enough interest rates to achieve that. Again, coming back to your question earlier about Congress's reaction, who would have believed that Congress would have accepted interest rates of this sort, the ghost of Wright Patman can be heard shouting in Congress but to no avail.

Question. Another one. What will the prime rate of federal funds be by mid 1982.

Answer. Volatile. I think we've learned that only a fool predicts the short term interest rates.

Question. Here's another: With 1982 being an election year, can we expect the politicians to adhere to the current policies?

Answer. Well, I think delays in the expected growth cycle are a good thing. I think stretching out the recession into 1982 is the only way that we're going to really change inflationary psychology, shake up labor markets, begin to get progress on the wages front. There's some weak indications of progress in private labor settlements already but I think as long as people have believed that this is going to be a one quarter recession or a two quarter recession, we really didn't make any progress on the wages front. I think a growing realization that this is a deflationary policy, that this is going to be a slack economy, will really help. What about the politics of that? I think the Administration is going to be judged in '82 not on whether it hits some particular target for the deficits, not on what happens to MIB, not on what happens to even the unemployment rate as long as it stays in the 9 percent and below range. But it's going to be judged by what happens to inflation. People still remember that the end of the 1970s was double digit inflation. They remember a CPI that hit almost 20 percent at one point in 1980 and if next year's inflation rate is down in the 7-8 percent range with the prospects for even lower inflation in 1983, I think politically that's going to be very sound.

Question. What's the chance of getting a more realistic consumer price index?

Answer. Technically there's no problem with getting it and the Department of Labor has been developing alternative indices. Politically there's a problem of getting it accepted because so many contracts are written in terms of a CPI, the people at least think they understand. I'm not sure that this is the time to change indices. The CPI bounces up to higher and higher inflation rates when the level of interest payments rise, interest rates rise. If the level of interest rates merely stays high, that doesn't put any extra inflationary thrust into the CPI. If interest rates come down and housing prices come down, those mistakes in the way the CPI is constructed, will actually show up as lower inflation rates. That will feed into COLA clauses, that will feed into reductions in the growth of Social Security benefits and other government index programs. So this is not the time to switch away from the CPI. It has done, I think, most of its mischief, and we'd like to stick with it and have some of that mischief undone as inflation interest rates come down.

Question. Are some of the cuts affecting the poor too much?

Answer. We're going to hear a lot of that from the press and from the opponents of the reduction but I think the evidence is that that's not true, that reducing food stamps of taking food stamps away from the most affluent 5 percent of the 22 million recipients, essentially a middle income group, is not taking it away from the poor I think that raising, or eliminating the subsidy for school lunches for my children, is not taking it away from the poor. That returning to the states the responsibility for local environmental projects is just putting the responsibility where it belongs, it's not taking it away from the poor. I think that, although they will no doubt find ways of dredging up special cases of people whose benefits have been cut, it'll be very hard to really make that case stick.

Question. How about CETA?

Answer. CETA I think has just been a terrible failure as a way of dealing with employment problems, a way of dealing with those people. Just a terrible failure, and I think that that's widely seen by all the labor market experts. It's just the wrong way of dealing with the unemployment problem.

Question. If the purpose of the tax bill was to take money away from housing, what's the purpose of the All-saver's certificate?

Answer. It was a mistake. It was a testament to the incredible speed and perfect timing of the lobbying by the banking industry. They came into Congress at a time when the 1981 Tax Bill was at its greatest state of confusion and they ran around and managed to line up a lot of support for this. ("It's only one year anyway and it will bail out the thrifts, and by the way, it'll help the banks.") Before people realized what had happened, their eyes were on much more important issues at that very moment. At that moment there was still an uncertainty as to whether the Administration's package of business tax cuts or the Democrat's package passed, whether the 1983 and 1984 part of the "personal rate reductions" would be part of the package or not. The All-savers thing, with its newspaper campaign and its incredibly effective work at the Congressional level, came flying through town and caught a lot of people by surprise. Some people signed up because they thought it would bail out housing. Some people thought it would help the Thrifts. Some people even thought it was good for saving. By the end, most people who mattered thought at least it would only last a year.

Question. What's the outlook for the dollar?

Answer. Well, we've seen already in a sense, that the rest of the world has responded, not to our high interest rates, but to this longer term outlook of strength of the American economy by bidding up the dollar and I think one cannot explain the rapid recovery in the dollar by anything else. In the short run, that's bad for our exports and good for our competitors who are trying to import into this economy. With a 30 percent change in effective exchange rates between this country and the rest of the world, it's not surprising that our exports have fallen substantially in the last few months. But I think that the dollar is going to remain strong, not nearly as strong as it currently had been, but that the fall is not going to be very substantial. I think there is a return to the kind of effective exchange rates relative to the purchasing power value of currency that we had 15 years ago and that its strength is going to last.

Question. What are the chances of convincing the labor movement that policies favoring savings are beneficial to them and the economy?

Answers. It doesn't seem to matter. Congress has definitely accepted it. Congress has definitely accepted the view that more savings is good for the American economy and I think we're going to see a further development of the kinds of proposals that were enacted this year.

I think we'll see that 15 percent interest exclusion on the first $6,000 of interest income raised from 15 percent to a larger percentage. I think that we're gradually moving away from an income tax structure that penalizes savings and investments toward a consumption tax that exempts savings or the income from savings.

Question. What is your forecast of real GNP growth between now and 1983?

Answer. I don't think anybody can really answer when the economy will turn around. I think that one of the lessons that should have come out of the 1970s is that we don't know how to do that. One of the reasons we've gotten into such a terrible mess is that people ask that question and economists pretend they know the answer. Once economists say that it's going to turn around but not until the fourth quarter of '82, then somebody comes up with a clever plan for stimulating demand in the second quarter of '82. But then the economist was wrong, in '82 the second quarter is very strong and we end up with more inflation. I think that is the greatest source of mischief, the continued belief that we can fine tune the economy. I don't think anybody knows. There are too many unknown about policy and about human behavior to forecast the details of something like that. [Applause.]

NV. I'm sorry to say that Dr. Feldstein will not be staying with us today. He's on his way to Alaska. He has a rather long flight. Then he's on to Japan. Dr. Feldstein, I'm sure I speak for the group in thanking you very much for your very clear and honest picture of how we got to where we are and what the Administration is attempting to do, despite the political rhetoric. Your presentation certainly renews my personal confidence in the President's program. I think it's up to all of us as business men to get behind it and really push it. Thank you again, Sir. [Applause.]

QUESTIONS SUBMITTED FOR THE RECORD FROM SENATOR DONALD W. RIEGLE

1. As of May 11, 1982 you termed the current recession "relatively modest thus far." How would you classify the recession today?

2. When do you expect the strong recovery promised by the Administration last spring?

3. What is your outlook for the economy for the remainder of this year? For 1983? Please indicate the following: (a) Rate of unemployment; (b) nominal and real GNP growth; (c) rate of capital spending; (d) factory utilization; (e) housing starts; and (f) auto sales.

4. You have repeatedly stated that although business is facing a higher cost of funds, it has an added incentive to invest because of the rapid acceleration of depreciation enacted by Congress in the Economic Recovery Tax Act of 1981. Despite these depreciation incentives, investment in new factories and equipment will rise by just 2% this year according to a recent Commerce Department survey. How do you explain this and what remedy do you suggest?

5. The Tax Equity and Fiscal Responsibility Act of 1982, recently signed into law by President Reagan, contained provisions for a withholding tax of 10% on investment and dividend income. What do you believe will be the effect of this measure on savings incentives? Did you support this provision?

6. Most economists say we need a resurgence of consumer spending in order to get economic recovery underway, and express concern that tight money will discourage both consumer and business spending. You are a leading advocate of policies to dis-

courage consumer spending—how do you reconcile that position with the need for a surge in spending to achieve economic growth?

7. In general do you support or disapprove of the Federal Reserve Board's tight monetary policy? What would you consider an appropriate target for M1 growth in 1983?

8. What changes—if any—would you recommend in the conduct of monetary policy?

9. You were quoted in the Washington Post of August 15, 1982 as believing that "if the inflation rate is above its optimal level, the economy should then be deflated to reduce the inflation rate, regardless of the temporary consequences for unemployment." What is the "optimal level" for the inflation rate? How do you distinguish temporary unemployment from long-term unemployment?

10. What do you consider an acceptable level of unemployment? In Michigan the current unemployment rate, as of August 1982, is 15.2%. Is that an acceptable level of unemployment? What, in your opinion, is the "full employment" rate of unemployment?

11. You have concluded in past studies of youth unemployment that the problem is concentrated in a relatively small group of disadvantaged workers whose low productivity prevents employers from hiring them at the minimum wage. If the problem is concentrated in a relatively small group, how do you explain the Federal Reserve Board's Mid-Year Monetary Policy Report figure that "black male teenagers experienced an unemployment rate of nearly 60 percent in June 1982."?

12. Do you support the current minimum wage law?

13. Is it your opinion that "the food stamp program is just a cash transfer disguised as a food program in order to attract political support."?

14. Is it true that you believe that, because of programs like Medicare and Medicaid, health insurance coverage is currently too comprehensive and that individuals have little reason to economize on health care? Is it your opinion that "The key . . . is to make the individual employee face the full cost of increased coverage beyond a legislated standard."?

15. If confirmed what specific recommendations would you plan to make to the President regarding social insurance programs?

16. What are your views on Federal assistance to state and local governments for such functions as education, community development and job training?

17. What do you believe should be the government's role in stimulating 1) housing, 2) mass transportation, and 3) urban development?

18. What steps do you think should be taken—if any—to stimulate consumer confidence and spur automobile sales?

19. Last week, a top international banking economist warned the House Committee on Energy and Commerce that the world banking system is "dangerously, indeed critically, overextended" and there is a serious risk of a "general seizure of the international banking system and a first order global financial crisis." Do you share any of these concerns?

ANSWERS TO QUESTIONS SUBMITTED BY SENATOR DONALD W. RIEGLE

1. On May 11, 1982 I noted that the unemployment rate had risen 2.2 percentage points from the 7.2 percent level at the business cycle peak in July 1981 and contrasted that with the 2.9 percent average rise in unemployment from peak to trough in previous postwar recessions. The current unemployment rate corresponds to a 2.6 percentage point rise and is therefore a smaller increase in the unemployment rate than was true on average in the previous recessions.

2. Because of the nature of the position for which I have been nominated, I believe it is inappropriate for me to make public forecasts at this time. Projections will of course be made by the council through our report at the appropriate time.

3. The answer to question 2 applies here.

4. Slow investment increase reflects the generally weak level of economic activity. Investment will increase as the recovery endures but additional investment incentives would be desirable as budgetary conditions permit.

5. The 10 percent withholding on investment and dividend income is likely to have a relatively small negative effect on savings. I did not take any position on this provision.

6. My concern is to encourage more saving as a long-run policy to facilitate capital formation and not as an activist policy in the cyclical context.

7. Since the money supply is currently outside the Fed's prespecified range and interest rates have dropped sharply, conventional definitions would not classify the Federal Reserve policy as "tight". I have generally supported the broad thrust of

the Federal Reserve policy. I think it is inappropriate for me as Chairman-designate to comment on an appropriate target for Federal Reserve policy.

8. As I noted in answer to question 7, I generally support the broad thrust of the Federal Reserve Board's approach to the conduct of monetary policy.

9. The quotation is from a theoretical article in an academic journal and can only be interpreted within the theoretical framework of that analysis. The "optimal" inflation rate in that context is best thought of as the optimal tax on the holding of money balances and depends on the general equilibrium properties of the model being analyzed.

As a practical matter, I believe the long-run optimal inflation rate is as close to zero as possible although at any time the optimum depends on the feasibility and economic costs of changing the inflation rate.

There is no clear distinction between temporary and long-term unemployment, although empirical studies of unemployment frequently use 26 weeks as a dividing line.

10. As a long-run goal, the unemployment rate should exceed zero only by the "frictional" unemployment required for healthy job search. It would clearly be better to have a rate lower than that which recently prevailed in Michigan. The "full employment" rate of unemployment is a technical term used by economists to denote the lower unemployment rate which, with the existing structure of labor markets and worker incentives, can be sustained without an increase in inflation. Econometric research generally places this unemployment rate in the 6 to 7 percent range.

11. Unemployed black male teenagers are clearly a disadvantaged group. The vast majority of teenagers are either students or working or both. The unemployed non-students constitute a small portion of all teenagers. The high unemployment rate in any subgroup reflects the exclusion of the out-of-the-labor-force students from the denominator.

12. My support for the current arrangement depends on what alternative is possible.

13. For some individuals, the food stamp program increases food consumption. For the majority of food stamp recipients, the program is functionally equivalent to a cash transfer. I believe that linking it to food makes it politically more attractive.

14. My stated views about the comprehensiveness of health insurance coverage refers primarily to private health insurance rather than to the Medicare and Medicaid programs. The quote refers to the idea that an individual will choose the amount of health insurance more wisely if he can receive an untaxed rebate for choosing a lower cost plan and must pay after-tax income for a much more comprehensive plan.

15. My recommendations to the President would be private. It would not be appropriate to state them publicly.

16. I do not currently have views on the subject of federal aid to state and local governments for these functions.

17. I do not currently have views on the federal government's role in stimulating housing, mass transport, and urban development.

18. Consumer confidence can be stimulated if the public believes that the Administration and Congress are following basic principles of economic policy in a consistent way. Lower long-run deficits achieved without raising taxes will reduce pressure in financial markets and help to stimulate the recovery.

19. I believe that it is important for the Treasury, the Federal Reserve and various international agencies, as well as private financial institutions, to monitor closely the developments in international banking. The current pressures on these debtor countries will be eased as real interest rates fall and terms of trade improve.